MISCELLANEOUS TAX LEGISLATION

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

H.R. 4667, H.R. 4948, H.R. 5177, H.R. 5470, H.R. 5573, H.R. 617,
H.R. 2402, H.R. 4917, H.R. 5985, H.R. 6218

JUNE 14; JULY 12, 1982

Serial 97–74

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
97-054 O WASHINGTON : 1982

H781-50

COMMITTEE ON WAYS AND MEANS

DAN ROSTENKOWSKI, Illinois, *Chairman*

SAM M. GIBBONS, Florida
J. J. PICKLE, Texas
CHARLES B. RANGEL, New York
FORTNEY H. (PETE) STARK, California
JAMES R. JONES, Oklahoma
ANDY JACOBS, JR., Indiana
HAROLD FORD, Tennessee
KEN HOLLAND, South Carolina
WILLIAM M. BRODHEAD, Michigan
ED JENKINS, Georgia
RICHARD A. GEPHARDT, Missouri
THOMAS J. DOWNEY, New York
CECIL (CEC) HEFTEL, Hawaii
WYCHE FOWLER, JR., Georgia
FRANK J. GUARINI, New Jersey
JAMES M. SHANNON, Massachusetts
MARTY RUSSO, Illinois
DON J. PEASE, Ohio
KENT HANCE, Texas
ROBERT T. MATSUI, California
DON BAILEY, Pennsylvania
BERYL ANTHONY, JR., Arkansas

BARBER B. CONABLE, JR., New York
JOHN J. DUNCAN, Tennessee
BILL ARCHER, Texas
GUY VANDER JAGT, Michigan
PHILIP M. CRANE, Illinois
BILL FRENZEL, Minnesota
JAMES G. MARTIN, North Carolina
L. A. (SKIP) BAFALIS, Florida
RICHARD T. SCHULZE, Pennsylvania
BILL GRADISON, Ohio
JOHN H. ROUSSELOT, California
W. HENSON MOORE, Louisiana

JOHN J. SALMON, *Chief Counsel*
JOSEPH K. DOWLEY, *Assistant Chief Counsel*
ROBERT J. LEONARD, *Chief Tax Counsel*
A. L. SINGLETON, *Minority Chief of Staff*

SUBCOMMITTEE ON SELECT REVENUE MEASURES

FORTNEY H. (PETE) STARK, California, *Chairman*

KEN HOLLAND, South Carolina
WYCHE FOWLER, JR., Georgia
MARTY RUSSO, Illinois
ROBERT T. MATSUI, California
CECIL (CEC) HEFTEL, Hawaii
FRANK J. GUARINI, New Jersey

JOHN J. DUNCAN, Tennessee
RICHARD T. SCHULZE, Pennsylvania
GUY VANDER JAGT, Michigan
W. HENSON MOORE, Louisiana

CONTENTS

MONDAY, JUNE 14, 1982

Page

Press release of Thursday, May 20, 1982, announcing hearing ... 1

WITNESSES

Department of the Treasury, Hon. John E. Chapoton, Assistant Secretary for Tax Policy ... 3

American Association of Colleges for Teacher Education, Franklin Zweig and Robert W. MacMillan ... 52
Apple Computer, Inc., Steven P. Jobs ... 24
Bank Street College of Education, Center for Children & Technology, Karen Sheingold ... 37
Benefit Designs, Inc., Patrick J. Hindert ... 81
Brown, Hon. Hank, a Representative in Congress from the State of Colorado ... 75
California State Department of Education, Don White ... 50
Capital Children's Museum, Ann W. Lewin ... 44
Eye Research Institute of the Retina Foundation, Richard Pharo ... 71
Gore, Hon. Albert, Jr., a Representative in Congress from the State ofTennessee ... 19
Hand & Associates, Houston, Tex., John S. Nolan ... 77
Hewlett-Packard Co., Emery H. Rogers ... 29
Higgins, David M., Overton, Lyman & Prince ... 85
Hindert, Patrick J., Benefit Designs, Inc ... 81
Institute for Medical Research, David R. Kaloupek ... 68
Jobs, Steven P., Apple Computer, Inc ... 24
Kaloupek, David R., Institute for Medical Research ... 68
Kruse, Richard, National Association of Secondary School Principals ... 57
Lewin, Ann W., Capital Children's Museum ... 44
MacMillan, Robert W., American Association of Colleges for Teacher Education ... 52
National Association of Secondary School Principals, Richard Kruse ... 57
National School Boards Association, Rayma C. Page ... 59
Nolan, John S., Hand & Associates, Houston, Tex., and Third Farm Credit District, Columbia, S.C ... 77
Overton, Lyman & Prince, David M. Higgins ... 85
Page, Rayma C., National School Boards Association ... 59
Pharo, Richard, Eye Research Institute of the Retina Foundation ... 71
Rogers, Emery H., Hewlett-Packard Co ... 29
Shannon, Hon. James M., a Representative in Congress from the State of Massachusetts ... 18
Sheingold, Karen, Center for Children & Technology, Bank Street College of Education ... 37
Third Farm Credit District, Columbia, S.C., John S. Nolan ... 77
University of Michigan, Center for Research on Learning and Teaching, Karl Zinn ... 39
White, Don, California State Department of Education ... 50
Zinn, Karl, Center for Research on Learning and Teaching, University of Michigan ... 39
Zweig, Franklin, American Association of Colleges for Teacher Education ... 52

SUBMISSIONS FOR THE RECORD

Page
American Association of School Administrators, Joseph J. Scherer, letter 121
American Council of Life Insurance, statement 113
Asp, William G., White House Conference on Library and Information Services Task Force, letter 125
Brown, Hon. Edmund G., Jr., Governor of the State of California, statement 121
California, State of, Hon. Edmund G. Brown, Jr., Governor, statement 121
Chodos, Laura B., White House Conference on Library and Information Services Task Force, letter 124
Fairfax County (Va.) Public Schools, Jay D. Jacobs, letter and statement 122
Hoye, Rev. Msgr. Daniel F., United States Catholic Conference, letter 123
Jacobs, Jay D., Fairfax County (Va.) Public Schools, letter and statement 122
Hon. Ray Kogovsek, a Representative in Congress from the State of Colorado, letter 107
Matsui, Hon. Robert T., a Representative in Congress from the State of California, statement 103
Orange Leader and Tribune, James B. Quigley, letter forwarded by Congressman Charles Wilson 104
Powell, Neal W., town of Taneytown (Md.), statement 76
Quigley, James B., Orange Leader and Tribune, letter forwarded by Congressman Charles Wilson 104
Scherer, Joseph J., American Association of School Administrators, letter 121
Taneytown (Md.), town of, Neal W. Powell, statement 76
United States Catholic Conference, Rev. Msgr. Daniel F. Hoye, letter 123
White House Conference on Library and Information Services Task Force:
  Laura B. Chodos, letter 124
  William G. Asp, letter 125

APPENDIX

H.R. 4667:
  Text 94
H.R. 4948:
  Text 98
  Hon. Robert T. Matsui, a Representative in Congress from the State of California, statement 103
  Orange Leader and Tribune, James B. Quigley, letter 104
  Taneytown (Md.), town of, Neal W. Powell, statement 76
H.R. 5177:
  Text 106
  Hon. Ray Kogovsek, a Representative in Congress from the State of Colorado, letter 107
H.R. 5470
  Text 109
  American Council of Life Insurance, statement 113
H.R. 5573:
  Text 114
  American Association of School Administrators, Joseph J. Scherer, letter . 121
  California, State of, Hon. Edmund G. Brown, Jr., statement 121
  Fairfax County (Va.) Public Schools, Jay D. Jacobs, letter and statement... 122
  United States Catholic Conference, Rev. Msgr. Daniel F. Hoye, letter 123
  White House Conference on Library and Information Services Task Force:
    Laura B. Chodos. letter 124
    William G. Asp, letter 125

MONDAY, JULY 12, 1982

Page
Press release of Friday, June 25, 1982, announcing hearing 127

WITNESSES

Department of the Treasury, Hon. John E. Chapoton, Assistant Secretary for Tax Policy 129

American Fishing Tackle Manufacturers Association, Thomas R. Schedler, Dave Kern, and Ralph Biederman 214
Army Mutual Aid Association, Maj. Kenneth F. Hanst, Jr., and George D. Webster 211
Biedermann, Ralph, Brunswick Corp and American Fishing Tackle Manufacturers Association 219
Brooklyn Union Gas Co., Fred J. Gentile and Harold J. Heltzer 179
Brunswick Corp., Ralph Biedermann 219
Cohen, Sheldon S., International Telephone & Telegraph Corp 202
Curtis, Carl T., Don Rich Co 157
de Lugo, Hon. Ron, a Delegate to Congress from the Virgin Islands 186
Drapkin, Dennis B., International Telephone & Telegraph Corp 202
Gentile, Fred J., Brooklyn Union Gas Co 179
Hanst, Maj. Kenneth F., Jr., Army Mutual Aid Association 211
Heltzer, Harold J., Brooklyn Union Gas Co 179
International Telephone & Telegraph Corp., Sheldon S. Cohen and Dennis B. Drapkin 202
Kern, Dave, Zebco and American Fishing Tackle Manufacturers Association 219
Kimmelfield, Neil, Virgin Islands Trade & Economic Development Institute 198
Luis, Hon. Juan, Governor, Virgin Islands 188
O'Connell, Frank, Transport Workers Union, AFL-CIO 222
Rich, Don, Co., Carl T. Curtis and J. B. Wilson 157
Schedler, Thomas R., American Fishing Tackle Manufacturers Association 214
Transport Workers Union, AFL-CIO, Frank O'Connell 222
Virgin Islands, Hon. Juan Luis, Governor 188
Virgin Islands Trade & Economic Development Institute, Neil Kimmelfield 198
Webster, George D., Army Mutual Aid Association 211
Wilson, J. B., Don Rich Co 157
Zebco, Dave Kern 219

SUBMISSIONS FOR THE RECORD

Jones, Hon. James R., a Representative in Congress from the State of Oklahoma, statement 230
U.S. Virgin Islands, Amadeo I. D. Francis, statement 247

APPENDIX

H.R. 617:
Text: 224
H.R. 2402:
Text 227
Hon. James R. Jones, a Representative in Congress from the State of Oklahoma, statement 230
H.R. 4917:
Text 231
H.R. 5985:
Text 234
Amadeo I. D. Francis, Government of the U.S. Virgin Islands, statement 247
H.R. 6218:
Text 248

MISCELLANEOUS TAX LEGISLATION

MONDAY, JUNE 14, 1982

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, D.C.

The subcommittee met at 1:40 p.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Fortney H. (Pete) Stark (chairman of the subcommittee) presiding.

Chairman Stark. The subcommittee will resume.

This afternoon, the subcommittee will receive testimony on five miscellaneous bills. They deal with charitable donations of technological and scientific equipment, the tax treatment of certain personal injury damage awards, certain rules relating to money purchase pension plans, and the conveyence of certain land to the United States.

The subcommittee will proceed in the usual manner, hearing first from the Treasury Department on all of the bills. We will then begin with testimony of H.R. 5573, the Technology Education Act of 1982, which I am pleased to say has received broad bipartisan support and currently has over 75 cosponsors.

I am hopeful that this hearing will provide an opportunity to fully examine the merits of this proposal from economic and educational standpoints.

In conclusion, I would remind all witnesses that they should summarize their testimony. All written statements will be included in the hearing record in their entirety.

Without objection, the press release announcing today's hearing will be incorporated into the hearing record.

[The press release follows:]

[Press Release of Thursday, May 20, 1982]

Hon. Fortney H. (Pete) Stark, Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, Announces a Public Hearing on Miscellaneous Tax Bills To Be Held Monday, June 14, 1982

Hon. Fortney H. (Pete) Stark, (D., Calif.,), Chairman of the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, announces a public hearing on miscellaneous tax bills to be held Monday, June 14, 1982. The hearing will begin at 1:30 p.m. in 1100 Longworth House Office Building, the Committee's main hearing room.

The lead-off witness at the hearing is expected to be Hon. John E. Chapoton, Assistant Secretary for Tax Policy, Department of the Treasury.

Testimony is invited on the following bills:

1. H.R. 5573—(Messrs. Stark, Shannon, Bafalis, Gephardt, Holland, Rangel, Archer and others)—The Technology Education Act of 1982—To amend the Internal

Revenue Code of 1954 to encourage contributions of computers to elementary and secondary schools.

2. H.R. 4667—(Messrs. Guarini, Forsythe, Howard, Florio, Roe, Rinaldo, Hughes, Dwyer and Fenwick)—To amend the Internal Revenue Code of 1954 to include certain tax-exempt organizations as eligible recipients of scientific property for purposes of the special computation of the charitable contribution deduction for such property.

3. H.R. 4948—(Mr. Matsui) To amend the Internal Revenue Code of 1954 to provide for the application of cash or deferred arrangement rules to money purchase plans.

4. H.R. 5177—(Messrs. Brinkley, Kogovsek, Kramer and Brown of Colorado)—To amend the Internal Revenue Code of 1954 to permit persons who convey certain lands in Colorado to the U.S. for the expansion of the Ft. Carson military installation to treat the conveyance of such lands as involuntary as involuntary conversions for the purposes of section 1033 of the Internal Revenue Code.

5. H.R. 5470—(Messrs. Jacobs, Holland, Guarini, Duncan of Tenn. and Vander Jagt)—To amend the Internal Revenue Code of 1954 to insure periodic payments for damages received on account of personal injuries.

Identical bills: H.R. 4356 (Messrs. Goldwater and Rousselot) H.R. 5732 (Mr. Holland)

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentation will be limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for Committee members to interrogate witnesses. The witnesses will be grouped as panels to expedite the hearing, and strict time limitations will be established for each panelist.

The following is an outline of the procedure to be followed by organizations and individuals who either may want to appear and testify during this hearing or file a written statement for the printed record of the proceedings. All requests should contain the following information:

1. The name of the witness, his title, address, firm affiliation and/or organization he will represent (as well as a telephone number where he or his designated representative may be reached).

2. If appearing in an individual capacity, a list of any clients at whose request or in whose employ the witness appears.

3. A topical outline or summary of comments and recommendations.

Requests to be heard must be made by telephone to Ms. Harriett Lawler [telephone (202) 225-3627] by the close of business, Wednesday, June 9, 1982. The telephone request should be followed by a formal written request addressed to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, witnesses scheduled to appear before the Subcommittee should comply with the following rules:

1. All witnesses must submit 75 copies of their prepared statement to the full Committee office, room 1102 Longworth House Office Building, not later than noon Friday, June 11, 1982.

2. Witnesses should not read their written statements to the Subcommittee, but should instead limit their oral presentations to a summary of the points included in the statement.

3. Not more than five minutes will be allowed for the oral summary.

Failure to comply with these requirements may result in the witnesses being denied the opportunity to testify in person or being deferred until all other testimony is heard.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, five copies are required and must be received by the close of business, Monday, June 28, 1982. The statements should be delivered to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office during the course of the hearing.

Chairman STARK. Representing the Treasury Department this afternoon is Hon. John E. Chapoton, Assistant Secretary for Tax Policy.

Buck, you may proceed with your testimony.

Without further objection, the record will remain open for written questions to be submitted to the witnesses and for additional information to be incorporated in the record.

Mr. Chapoton, you may proceed, in any manner you see fit.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Thank you, Mr. Chairman. I will summarize our position on each of the bills in very short fashion, I think, and then be happy to have an opportunity for questions. I will make my summary brief.

The first two bills are combined, 5773 and 4667. They both deal with deductions for charitable contributions of certain inventory items.

Under current law, a corporation may deduct the cash or property contributed to a qualified charity, but in the case of inventory, the sale of which it would produce ordinary income, it is limited to the corporation's basis in the property.

Under current law, there may not be deducted as a charitable contribution in any one taxable year an amount in excess of 10 percent of the corporation's taxable income for the year.

If the contributions exceed that amount, there is a 5-year carryover.

There are in current law two exceptions to the general rule that deductions for gifts of ordinary income property are limited to basis. One is an exception for corporate gifts of inventory for the care of the ill, the needy or infants; and the second was added by last year's tax bill, ERTA, and involves corporate gifts of scientific equipment and apparatus to colleges and universities for research and experimentation.

In both cases, the amount allowable as a deduction is the taxpayer's basis plus one-half of unrealized appreciation but the total deduction cannot exceed twice the taxpayer's basis in the property.

These two bills would extend——

Chairman STARK. How does that differ from the basis we are asking for in 5573?

Mr. CHAPOTON. I would just say, no difference. They both would extend that rule to the other types of gifts.

Chairman STARK. But you approve on the one hand?

Mr. CHAPOTON. No; we are not—we support the general rule under existing law that inventory property gifts deduction be limited to the taxpayer's basis.

Chairman STARK. You opposed it last year in the ERTA rules.

Mr. CHAPOTON. I am sure we did oppose it. It came up in the Senate Finance Committee. We did not oppose it?

Chairman STARK. I was wondering, since you supported it, if you are not estopped from changing courses in the middle of the stream.

But that is just a thought I had to interject.

Mr. CHAPOTON. I will go back and check that thought out as well. I think, as memory serves me, it came up in the Senate Finance Committee. There was before last year an exception for gifts to the ill, needy, and infants, and this came up in connection with the research and development credit and the effort was to extend gifts of scientific-type equipment to certain limited instances.

But as we see here, and as we all claim to learn, once you see exceptions come into the law, then the attempt is made to broaden the exceptions and it is difficult to limit such attempts unless one stands with the principle.

The principle we are attempting to stand with today is that of existing law, the general rule under existing law, that gifts be limited; that is, the deduction be limited to the taxpayer's basis.

The bills before you would also—H.R. 5573 would increase the 10-percent limit of taxable income limit in any year to 30 percent of taxable income for contributions of qualified property.

H.R. 4667 would expand the special exception for gifts of scientific research equipment in ERTA to include gifts to any exempt organization other than a private foundation, so long as the organization is organized primarily to conduct scientific research.

As stated, we oppose both of these bills, even though we recognize that the ultimate purpose they attempt to serve—to support computers in primary and secondary schools in H.R. 5573 and increased support for scientific research in H.R. 4667—may be highly desirable when viewed in isolation. But we would point out that the effect of these bills would be to have the Federal Government fully or almost fully fund these programs through the tax system, even though they are administered wholly by private businesses.

We object to this for a number of reasons. First, the value of the tax benefit conferred by the increased charitable deduction would approximately equal the taxpayer's cost in the contributed property. If you assume as an example that the property cost $1,000 and is now worth $3,000, under this bill, the taxpayer would be entitled to a deduction of $2,000, that is basis plus half of the unrealized appreciation, or a total of $2,000.

This would grant a taxpayer a tax savings of about $1,000, which is about equal to the taxpayer's cost in the equipment, for example.

The effect is that the Federal Government would be purchasing the equipment from the corporation at its cost. But the donor corporation would determine the recipient of the equipment, not the Federal Government who is paying the cost of the gift.

Also, while we do not question to any degree the motives of the corporate proponents behind this legislation, we would simply point out that a computer manufacturer could hardly be faulted if it favors schools whose students come from families who might be expected to buy home equipment, or donated products that were not selling well currently.

Chairman STARK. As you know, that's the very reason for limiting the concept to one set of equipment per school.

Mr. CHAPOTON. Right.

Chairman STARK. To specifically counter that argument. The inclination may be for a manufacturer to contribute to schools in the neighborhood of its factories or where its executives live.

But you can only donate one unit per school. I think there should be some effort to see that schools in lower income areas or remote areas have the same opportunity.

Mr. CHAPOTON. Well, I point out that we do support the policy behind the rule of existing law. That rule produces about the same tax benefit as if the donor had sold the property for its full value and gave the cash proceeds to charity.

This is a substantial tax benefit. Absent this rule, most, if not all, of the economic consequences of making a gift will be borne by the Federal Government. As we stated in our written statement there would virtually be no charity in charitable giving and we think that runs counter to a very sound policy of making the donor bear a significant portion of the cost any time there is a charitable gift.

We also object to an increase in the 10-percent limit to 30 percent on a one-time basis. That would allow these corporations who benefit from this legislation to obtain three times the benefit from contributions of computers and other sophisticated technological equipment, than could be obtained by a corporation donating cash or other property for another cause.

We think the existing limit places a reasonable limit on the ability of corporations and their shareholders to divert potential tax revenues away from the Federal Government and to the particular activities they favor.

We also point out some concerns, Mr. Chairman, of the possible competitive considerations motivating the intended beneficiary of H.R. 5573.

This presents us with some significant concerns.

The case law has many examples of taxpayers whose charitable contributions have been limited, in whole or in part, because of some indirect benefit flowing to the taxpayer from the gift.

You always have the question of good will in those cases. Even aside from that difficult question, though, we can expect that the companies that supply this equipment to schools can expect service contracts and we think they can anticipate future sales to the schools and to the families of their students.

We raise the question whether this is the disinterested generosity that the deduction is intended to reward.

So we do oppose both of these bills on those grounds and the others that I have stated in detail in the statement.

Turning to H.R. 4948, this legislation would extend to salary reduction money purchase pension plans in existence on June 27, 1974, the rules applicable to cash or deferred arrangements under qualified profit sharing or stock bonus plans.

This is very targeted legislation because of the unusual situation which exists as to plans created before June 27, 1974, which are cash and deferred plans.

There is a long history involved here. Basically any deferral arrangement under plans utilized before 1974 or 1975 could have been denied qualified status under Treasury regulations proposed in 1972.

A freeze was put on those regulations in 1974, protecting salary reduction arrangements under plans in existence on June 27, 1974. Nothing was done until 1978, when section 401(k) was adopted, giving qualified status to cash or deferred profit sharing and stock bonus plans.

This legislation, section 401(k), does not now cover money purchase pension plans, so the salary reduction arrangements under money purchase pension plans in existence before 1975, as well as under money purchase plans, formed after 1974 and in the future, will not be covered under section 401(k).

There are, I point out in the statement, three remaining issues involved in the area of cash and deferred arrangements. The first concerns deferrals under money purchase plans in existence before June 27, 1974. The second involves deferrals under money purchase plans established after that date and established in the future; and the third involves plans maintained for employees of tax-exempt organizations.

Deferrals under these three types of plans will not be protected at all if the two sets of proposed regulations which have been issued by the Treasury Department are made effective, so we think legislation is needed to cover all three cases.

We support the approach, the results reached by H.R. 4948. It resolves the first of those three remaining questions and for the reasons and with the limitations stated in my written statement, Mr. Chairman, we would support going further than this legislation and solve the other two problems as well.

Indeed, we think it is important that Congress does deal with this broader question of deferrals under all money purchase plans, and under plans maintained by tax-exempt organizations.

H.R. 5177 deals with sales of land for Fort Carson military installation. It would treat the sales as involuntary conversions under section 1033 of the code, an involuntary conversion is given tax-free rollover treatment if the proceeds are reinvested within the restrictions contained in that section of the law.

We understand the land involved here is some 230,000 acres adjacent to the Fort Carson military installation. We understand it is owned by approximately 40 individuals, and that to date, none of it has been acquired by the Army.

We, in brief, Mr. Chairman, do not understand the facts involved in the particular cases. If they qualify as involuntary conversions under existing law, that is, if the land were sold under threat of condemnation, section 1033 would apply.

If, for some reason, they do not meet the constraints of existing law, we know of no reason why this group of taxpayers or this property should be carved out and treated more favorably than other taxpayers in similar situations and, therefore, we oppose this as some type of special-relief legislation.

Finally, H.R. 5470 involves the treatment of payments by a person who has settled a claim for personal injuries or sickness, payable in periodic payments where payments are deferred in time, and the defendant settles the claim by giving a fixed sum to a third party who undertakes to make the payments periodically to the injured party.

Under existing private rulings issued by the Internal Revenue Service, no taxable income is recognized to the third party who receives the sum in return for agreeing to make the periodic payments to the injured party, provided the third party turns around and uses the funds received to purchase an annuity contract.

When the annuity contract pays off to the third party, the third party recognizes income under section 72 of the code and the amounts paid to the plaintiff are deductible when paid out as periodic payments.

That is basically the administrative practice under existing law.

As I understand it, this bill is supposed to codify existing law. Our reading is that it goes beyond existing law, and for that reason, we object to the bill as drafted.

It is my understanding that the proponents of the legislation only intend to codify existing law and would not object to limiting amendments that do that. We would be receptive to reviewing those amendments and seeing if they raise any further problems.

We would like to raise one other problem. If you have periodic payments in a damages situation, the effect is that the earnings on the amount ultimately paid to the injured party is not taxable income when received in the future, because it is excluded from income under section 104, which treats both the principal and interest as part of the damage claim; on the other hand, the party making the payment, either the third party in this case or the basic defendant in the usual case, deducts the full amount of the payments.

So there is a slippage there. We simply want to look at that situation. This is not a new problem. This is ongoing for some time, but we want to just review that situation.

For the reasons stated, we object to the bill in present form.

Mr. MATSUI. Mr. Chapoton, although this is not my bill, I do have an interest in it. If the amendments should result in the legislation codifying present administrative practices of the IRS, would you have no objection to it?

Is that correct?

Mr. CHAPOTON. I don't want to state it unqualifiedly, Mr. Matsui. I believe we would reach that result, but I want to look at the effect of the bill with the amendments.

Obviously, we are satisfied with the existing administrative practice. If we did run across a problem in review, we might have to come forward with that, but I think we would not object.

That is my conclusion now, but I don't want to be held to that until we review the amendments.

Mr. MATSUI. Even if it codified existing administrative practices, you are not——

Mr. CHAPOTON. One reason I am hedging just a bit is, when you look at this area, it just points out in cold relief that there is slippage here. You have a clear incentive for a recipient of a damage payment to take that damage over a period of years because the earnings go untaxed. Contrast that situation with the situation where a plaintiff would get $100,000 today, or would get $150,000 over 10 years.

The extra $50,000 will be tax-free for the recipient because it is treated as damages he receives in the personal injury suit.

On the other side, if the $50,000 is earned by the payor, it will be deducted when payed so that that income slips through the system.

Now, that is not a new problem and I don't want to say we want to fix the world here, but I think I would like to review the extent of that problem.

Mr. **Matsui**. Thank you.

Chairman **Stark**. All right.

Mr. **Chapoton**. That concludes the summary of our statement, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. chairman and members of the subcommittee, I am pleased to have this opportunity to present the views of the Treasury Department on the following five bills: H.R. 5573, which would provide special rules for the deduction of charitable contributions of computers and other technological equipment to primary and secondary schools; H.R. 4667, which would increase retroactively the charitable contributions deduction for gifts by corporations of newly manufactured scientific equipment to certain scientific research organizations; H.R. 4948, which would extend the rules for qualified cash or deferred compensation arrangements to salary reduction arrangements under certain money purchase pension plans; H.R. 5177, which would provide that sales of land to the U.S. Army for the Fort Carson military installation shall be treated as involuntary conversions under section 1033 of the Internal Revenue Code; and H.R. 5470, which concerns the tax treatment of certain arrangements for the periodic payment of damages for personal injuries.

I will discuss the Treasury Department's views on each of these bills in turn.

H.R. 5573 AND H.R. 4667—CHARITABLE CONTRIBUTIONS OF COMPUTERS AND SCIENTIFIC RESEARCH EQUIPMENT

Both H.R. 5573 and H.R. 4667 deal with deductions for charitable contributions of certain inventory items by corporations.

The Treasury Department opposes both of these bills.

Background

Under current law, a corporation may deduct, within certain limitations, the amount of cash or other property contributed to qualified charitable organizations. In the case of contributions of inventory and other property whose sale would give rise to ordinary income, the amount of the deduction is limited by section 170(e) of the Code to the taxpayer's basis in the property. The total amount any corporation is permitted to deduct as a charitable contribution in any one taxable year is limited to 10 percent of the corporation's taxable income for such year, computed without the charitable deduction and with certain other adjustments. If the corporation's total contributions during the taxable year exceed their percentage, the excess may be carried forward and deducted over the five succeeding years, subject to the percentage of taxable income limitation in those years.

There are currently two exceptions to the general rule that the deduction for gifts of ordinary income property is limited to the donor's basis in the property. The first exception concerns corporate gifts of inventory to be used for the care of the ill, the needy, or infants. The second exception, which was added to the Internal Revenue Code by the Economic Recovery Tax Act of 1981 (ERTA), involves corporate gifts of scientific equipment and apparatus to colleges and universities for research and experimentation. In both cases, the amount of the deduction is equal to the taxpayer's basis in the property plus one-half of the unrealized appreciation, not to exceed twice the taxpayer's basis in the property.

Description of H.R. 5573 and H.R. 4667

H.R. 5573 would allow corporations (other than Subchapter S corporations, personal holding companies or certain service companies) larger deductions than under current law for charitable contributions of computers or other "sophisticated technological equipment or apparatus" which is of an inventory nature if such equipment is contributed to primary or secondary schools for use in educating students. Only contributions made within one year of the date of enactment of H.R. 5573 would qualify. If all the conditions of the bill are satisfied, the amount of the allowable deduction will be determined in the same manner as under the two special exceptions provided by current law. That is, the donor corporation could deduct the sum of its basis in the property plus one-half the unrealized appreciation in such property, but in no event would the deduction exceed twice the taxpayer's basis in the contributed property. The bill also would increase a corporation's allowable deductions from 10 percent to 30 percent of its taxable income for contributions of such property. We understand that an amendment to H.R. 5573 is under consideration which would increase the limitation for carryforward deductions to 30 percent as well. H.R. 5573 thus could double the deduction otherwise allowable for gifts of inventory property and could triple the amount of such deductions allowable for any one year.

H.R. 4667 would expand the special exception provided by ERTA for gifts of scientific research equipment to include corporate gifts to any exempt organization, other than a private foundaiton, which is organized and operated primarily to conduct scientific research.

Discussion

Treasury is strongly opposed to both H.R. 5573 and H.R. 4667. We recognize that the end results which the bills seek to promote—computers in every primary and secondary school in the case of H.R. 5573 and increased support for scientific research in the case of H.R. 4667—may be highly desirable if viewed in insolation. Nevertheless, the effect of these bills would be to have the Federal government fully, or almost fully, fund these programs through the tax system, even though they are to be administered by private businesses. There are numerous reasons why it is not appropriate to use the tax system for these purposes.

In many cases, the value of the tax benefit conferred by the icnreased charitable deduction to be allowed by the bills would approximately equal the taxpayer's cost of the contributed equipment. For example, if it cost the corporation $1,000 to produce equipment which it could sell for $3,000, the corporation would be entitled to a deduction of $2,000 for a charitable contribution of the equipment in the situations covered by the bills. This deduction would produce a tax benefit to the corporation of approximately $1,000. In effect, the Federal government would be purchasing the equipment from the corporation at its cost.

Moreover, the donor corporations would determine the recipients of the equipment. As drafted, neither bill provides the government any right to oversee the contribution programs or to insure that they are administered in accordance with governmental policy. Although we assume it is not the intent of the proponents of the computer donation program contemplated by H.R. 5573, a computer manufacturer could hardly be faulted if it placed its computers in schools whose students come from families that would be most likely to have the financial resources to purchase similar equipment for home use. Yet a Federal outlay program targeted at these same relatively well-off families would hardly meet with Congressional approval. Similarly, with respect to the donations of scientific research equipment contemplated by H.R. 4667, we doubt that Congress would be willing to make direct purchases of such equipment for the institutions receiving the equipment without some showing of need by those institutions.

Additional problems arise from the fact that the amount of the permissible deduction would depend upon the fair market value of the donated equipment. There would be significant potential for abuse through claims of inflated values, particularly where the donated product is not selling well in the current market.

Further, we believe there are sound policy reasons behind the general rule of section 170(e) that limits the deduction for gifts of ordinary income property to a taxpayer's basis in such property. This general rule produces the same tax benefit as if the donor sold the property for its full value and gave the cash proceeds to charity. This tax benefit is substantial. Absent this rule, most if not all of the economic consequences of making the gift could be borne by the government. In fact, absent the rule, gifts and ordinary income property could be made at virtually no cost to the taxpayer—the tax benefit could almost equal the proceeds (net of taxes) which could be realized from the sale of the property. In such a case, there would be virtually no charity of charitable giving. Although the method for computing the charitable contribution deduction under these bills does not go so far as to cause taxpayers to be indifferent between giving inventory to qualifying organizations or selling it, the bills would greatly reduce the economic distinction between the two transactions. Thus, the bills run counter to the policy of requiring donors to bear a significant portion of the cost of charitable giving.

We realize that current law provides exceptions to the general limitation on deductions for charitable gifts of ordinary income property in the case of contributions of inventory items such as food, drugs and medical equipment to certain charities, and in the case of gifts of certain scientific equipment to colleges and universities.

We also realize that primary and secondary schools and scientific research institutions would benefit as much from donated equipment as would colleges and universities. However, the more exceptions that are made to the general limitation of section 170(e), the more difficult it becomes to rationalize different treatment for different taxpayers and property. For the reasons previously discussed, we believe that the general principle of section 170(e) is valid and should not be eroded by additional special exceptions.

Treasury also objects to the proposal in H.R. 5573 to increase the maximum amount allowable as a deduction for the gifts covered by the bill from 10 percent to 30 percent of the donor's taxable income. By increasing the maximum allowable deduction, H.R. 5573 would permit a favored corporation to obtain 3 times the benefit from its contributions of computers or other sophisticated technological equipment than could be obtained by a corporation donating cash or other types of property for any other cause.

The existing limitation on the maximum allowable charitable contributions deduction for corporations is based on sound policy grounds, including the need to protect Federal revenues and to place a reasonable limit on the ability of corporations and their shareholders to divert potential tax revenues away from the Federal government and to the particular activities they favor. The Economic Recovery Tax Act increased the limitation from 5 percent to 10 percent of a corporation's income, and we believe that the present limitation is appropriate.

Further, H.R. 5573 would only apply to gifts made within a one year period. While the purpose of this time limitation may be to limit the revenue loss from this exception, it is doubtful that many in the computer industry will be able to take advantage of this provision. We understand that, in general, the computer industry does not carry large inventories because rapid advances in technology often make current models obsolete. Taxpayers who are backlogged on orders would be unable to take advantage of the provision. Thus, those companies that could use the provision would have a significant advantage. We understand that an amendment to the bill which would qualify gifts made between February, 1983 and February, 1984 is being considered in order to provide other companies an opportunity to increase production to take advantage of the legislation. However, we question whether many other companies will be able to do so.

The competitive considerations motivating the primary intended beneficiary of H.R. 5573 also present significant tax policy concerns. The case law is replete with examples of taxpayers whose charitable contributions have been limited in whole or in part because of some indirect benefit flowing to the taxpayer from the gift. We realize that it is difficult to apply this indirect benefit test to corporations which may expect to benefit from the good will generated by their charitable gifts. However, there is potentially more than goodwill to be derived from this bill by those companies that can take advantage of it. The companies that supply equipment to schools can at least expect service contracts for that equipment and at best can anticipate future sales to the schools and the families of their students. We question whether this is the sort of detached and disinterested generosity that the charitable contribution deduction is intended to reward.

In summary, Treasury opposes both H.R. 5573 and H.R. 4667 because they would further erode the general principle that deductions for gifts of inventory should be limited to the donor's basis in that inventory and because they do so in a narrow fashion that benefits particular industries. We are particularly troubled by H.R. 5573 because it goes further than current exceptions to the general principle by increasing the percentage limitation for qualifying corporations. Moreover, H.R. 5573 is likely to benefit only a very few taxpayers who, far from exhibiting the generosity typically associated with charitable giving, hope to reap substantial commercial rewards from their gifts as well as the tax benefits made available by this provision.

H.R. 4948—EXTENSION OF CASH OR DEFERRED PLAN RULES TO SALARY REDUCTION ARRANGEMENTS UNDER MONEY PURCHASE PENSION PLANS

H.R. 4949 would extend to salary reduction money purchase pension plans in existence on June 27, 1974, the rules applicable to cash or deferred arrangements under qualified profit sharing or stock bonus plans.

Treasury supports H.R. 4948.

Background

H.R. 4948 would amend section 401(k) of the Internal Revenue Code to permit the tax qualification of certain money purchase pension plans in existence on June 27, 1974, which at that time provided for plan contributions under salary reduction arrangements. The narrow focus of the bill can be explained by the long history of these cash or deferred arrangements ("CODAs"), under which an employer gives the employee a choice between being paid a specified amount in cash as current compensation, or having that amount contributed to a retirement plan. Under "cash option" CODAs, the deferred compensation is an annual bonus, while under "salary reduction" CODAs, the deferred compensation represents either a reduction in the employee's basic or regular rate of compensation, or a foregone increase in such compensation.

Long before the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"), the Internal Revenue Service, in Rev. Rul. 56-497, upheld the tax qualification of any cash or deferred profit sharing plan, where over one-half of the plan participants electing deferral are among the lowest-paid two-thirds of all eligible employees. In later rulings, the Service imposed upon salary reduction plans the additional limitation that the employee could not reduce his salary by more than six percent.

In December 1972, the IRS proposed regulations that would have taxed employees currently on all income that they had an option to receive currently, even if that amount were deferred into a qualified profit sharing or money purchase plan. Later, in February 1978, additional regulations were proposed that would have taxed to the employee amounts deferred under an "individual option" salary reduction agreement under a nonqualified plan or arrangement. Although the 1972 proposed regulations applicable to qualified plans were withdrawn in 1978, the withdrawal notice indicated that the Service had not changed its general position opposing salary reduction arrangements.

In reaction to the 1972 proposed regulations, and in order to allow time for Congress to study the entire area, ERISA in 1974 provided for a temporary freeze on the promulgation of final regulations regarding salary reduction arrangements in existence on June 27, 1974. Accordingly, provided that the plans satisfied the requirements of pre-1972 law, employer contributions made under salary reduction arrangements to profit sharing or money purchase plans would not be includible in the income of the covered employees. This freeze, which originally applied until January 1, 1977, was twice extended by specific legislation, but it expired on January 1, 1980.

The Revenue Act of 1978 settled some of the controversy over the salary reduction issue, through the enactment of Code section 401(k), establishing special qualification rules for old and new profit sharing and stock bonus plans containing salary reduction features. Of particular note are the special eligibility and nondiscrimination rules provided for these plans as an alternative to the normal nondiscrimination tests applicable to qualified plans. Under these special rules, the actual average deferral percentage for the highest-paid one-third of all participants must not be more than 1.5 times (or, in certain circumstances, 2.5 times) the average deferral percentage for the other plan participants. These new rules were not applied, however, to salary reduction arrangements under money purchase pension plans. The proposed regulations under section 401(k), which were issued in November 1981, follow the statute and therefore do not protect salary reduction arrangements under money purchase plans, regardless of whether these plans were in existence on June 27, 1974.

The Revenue Act of 1978 also dealt with nonqualified salary reduction arrangements, first by granting tax qualification to deferrals under eligible state and local deferred compensation plans, and second by barring the Service from issuing regulations or rulings covering nonqualified salary reduction arrangements of taxable employers. No rules were provided by the 1978 Act for nonqualified salary reduction arrangements of tax-exempt employers.

There are three remaining issues raised by the various sets of proposed regulations on salary reduction arrangements which have not yet been resolved by Congress. First, deferrals under salary reduction money purchase plans in existence on June 27, 1974 will be taxed if the 1981 proposed regulations implementing the CODA rules enacted by the 1978 Revenue Act are made final, because the ERISA freeze protecting these pre-1975 plans expired on January 1, 1980. Second, deferrals under any salary reduction money purchase plan established after June 27, 1974 will be taxed if the 1981 proposed regulations are made final. (These plans were never protected by the ERISA freeze.) Finally, deferrals at an individual's option by employees of tax-exempt organizations will be taxed if the 1978 proposed regulations dealing with nonqualified salary reduction arrangements are made final, because the freeze enacted by the 1978 Revenue Act protected only salary reduction arrangements of taxable organizations.

Description of H.R. 4948.

H.R. 4948 solves the first of these three remaining salary reduction issues, by permitting any money purchase plan including a salary reduction arrangement in existence on June 27, 1974, to continue the salary reduction arrangement after December 31, 1979. However, these plans would not be permitted to increase the level of either employer or employee contributions above the level provided by the contribution formula in effect on June 27, 1974. In addition, for plan years beginning after December 31, 1980, these pre-1975 salary reduction money purchase pension plans would be eligible to qualify under the special alternative eligibility and nondiscrimination standards enacted by the 1978 Revenue Act for cash or deferred profit sharing and stock bonus plans.

Discussion

Treasury supports H.R. 4948, in recognition of the fact that the disqualification of salary reduction arrangements under the plans which were in existence on June 27, 1974, would no doubt reduce both employee participation and the level of retirement contributions by those employees who continue to participate in the plans. These plans have been operating for nearly eight years under the expectation that Congress would enact some rules permitting their continued operation. Now that the statutory freeze protecting these plans has expired, two alternatives will remain if the existing law is applied to them: (1) the plans will have to be amended to replace the shared employer-employee funding with what would probably be a reduced level of employer-only funding; or (2) the employees will be taxed on their share of contributions, which will require a greater cash outlay by the employee to maintain the same level of retirement savings. Either result is undesirable. Accordingly, Treasury supports this proposal to permit the continuation of pre-1975 salary reduction arrangements under money purchase pension plans.

In addition, Treasury would recommend that Congress make a further attempt to solve the two remaining salary reduction issues outlined above, relating to money purchase plans established after June 27, 1974, and to nonqualified deferred compensation arrangements of tax-exempt organizations. We support the concept of extending the section 401(k) CODA rules to all money purchase plans, because, in contrast to CODA contributions under a profit sharing plan, contributions under a money purchase plan can be made even if the employer has no current or accumulated profits. Thus, companies without strong profit positions, which could not promise annual contributions to a profit sharing plan, could promote regular retirement savings through salary reduction arrangements under a money purchase pension plan. The imposition of the special participation and nondiscrimination standards upon these plans will assure the provision of retirement income benefits for rank-and-file employees.

With respect to the nonqualified salary reduction arrangements of tax-exempt employers, Treasury would recommend that these arrangements be made subject not only to special participation and nondiscrimination standards, but also to some maximum deferral limits. Here again, the special qualification rules will encourage broad-based, nondiscriminatory participation in the plans, while the imposition of ceilings on the deferrable amounts will prevent the accumulation of tax-favored savings beyond the level necessary to provide adequate retirement income. However, pending development of these statutory solutions, Treasury, supports the enactment of H.R. 4948.

H.R. 5177—TREATMENT OF SALES OF LAND FOR FORT CARSON MILITARY INSTALLATION AS INVOLUNTARY CONVERSIONS

H.R. 5177 would treat any sale of privately owned land located in the vicinity of Purgatory River Canyon and Pinon Canyon, Colorado, to the United States for the expansion of the Fort Carson military installation, as an "involuntary conversion" within the meaning of section 1033 of the Code. This would qualify any gain realized on the sales for nonrecognition treatment under section 1033 if the proceeds of the sales are timely reinvested in property similar or related in service or use to the property sold.

The Treasury Department is opposed to H.R. 5177.

The Military Construction Authorization Act of 1982 (Public Law 97-99) authorized the U.S. Army to acquire approximately 230,000 acres of land adjacent of the Fort Carson military installation for use by the Army. It is our understanding that this property is owned by approximately 40 persons and that as of today none has been acquired by the Army.

Section 1033 of the Code provides that an involuntary conversion may result from, among other things, the requisition or condemnation of property or the threat or imminence of requisition or condemnation. Thus, if the contemplated sales of land to the U.S. Army for the Fort Carson military installation result from requisition or condemnation or from the threat of such actions, the sales would be treated as involuntary conversions under existing law. Without knowing the specific facts of each individual case, however, there is no way of knowing if any particular sale would satisfy this test.

H.R. 5177 would treat the sales in question as involuntary conversions without regard to whether they resulted from requisitions or condemnations or the threat of such actions. Treasury opposes this approach. The appropriate income tax treatment of the sales should depend upon the application of the normal rules of section 1033 to the particular facts of each case. If controversies develop with respect to the treatment of particular sales as involuntary conversions under existing law, such controversies should be resolved by the courts, which are equipped to ascertain the relevant facts and apply the established legal principles to them. Such matters should not be resolved through private legislation.

Moreover, assuming that there are cases in which sales of land to the U.S. Army for the Fort Carson military installation would not qualify as involuntary conversions under existing law, the special treatment provided by the bill would violate basic principles of fairness and equity. There is no valid reason to grant to certain landowners in Colorado special relief from the income tax rules by which all other taxpayers must abide.

H.R. 5470—TREATMENT OF CERTAIN ARRANGEMENTS FOR PERIODIC PAYMENT OF PERSONAL INJURY DAMAGES

This bill deals with the income tax treatment of certain arrangements for the periodic payment of damages on account of personal injuries or sickness. The bill is substantially identical to two other bills, H.R. 4356 and H.R. 5732.

The Treasury Department opposes H.R. 5470.

Background

Under section 104 of the Internal Revenue Code, damages received on account of personal injuries or sickness are excluded from the income of the recipient. In administrative rulings, the Internal Revenue Service has held that section 104 excludes from income the full amount of periodic payments received on account of personal injuries or sickness, provided the recipient has not actually or constructively received amounts used to fund the periodic payments. The IRS also has held that under section 104 the recipient of periodic damage payments will not be taxed when funds are transferred to a third party by the person liable for the damages if the obligation to make periodic payments is assumed by the third party, again provided that the recipient of the periodic payments is not deemed to be in constructive receipt of the funds transferred.

Additionally, in private letter rulings, the Service has ruled that, where a lump sum payment is transferred to a third party by a person liable for damages and is used immediately to purchase an annuity to fund an obligation to make periodic damage payments assumed by the third party, the third party will recognize no income upon receipt of the lump sum payment. Proceeds of such an annuity contract are taxed to the third party under the rules of section 72 of the Code. However, amounts included in income by the third party are deductible when paid out as periodic damage payments.

Description of H.R. 5470

Basically, H.R. 5470 would amend the Code to provide specifically that:

(1) A third party assuming the obligation to make periodic payments of damages for personal injuries or sickness would be entitled under section 104 to exclude from gross income any amounts received from the person liable for such damages if those amounts are applied to satisfy the obligation assumed by the third party. The exclusion from gross income would apply without regard to whether the third party immediately uses the amounts received to purchase an annuity contract to fund the damage payments. It is not clear, however, what method would be used to determine the portion of the amounts received by the third party that will be considered as having been applied to satisfy the periodic damage payment obligation.

(2) Periodic payments received as damages on account of personal injuries or sickness would be excluded from the gross income of the recipient under section 104 whether received "from or through" the "person originally liable" or an "assignee

or the person originally liable," provided that the recipient's rights against the assignee are sufficiently limited.

(3) The third party would be allowed to deduct all amounts paid to the recipient as ordinary and necessary business expenses under section 162 of the Code. However, we understand that the intent is to permit such deductions only to the extent that the third party has included such amounts in income, and that the bill will be revised to limit the deduction to that amount.

Discussion

H.R. 5470 does not merely codify the existing position of the Internal Revenue Service with respect to periodic payment arrangements involving a third party assignee. Admittedly, certain provisions of the bill do codify existing administrative interpretations. However, the bill would provide a substantial new benefit to third parties that assume obligations to make periodic damage payments.

As I have previously stated, the Internal Revenue Service has ruled privately that a third party may exclude from income the amounts received from the person originally liable for the damages to the extent used to purchase an annuity to fund the periodic damage payment obligation. The bill would allow the third party to exclude such amounts without regard to whether the funds are used to acquire an annuity contract.

H.R. 5470 does not make it clear how the third party assignee would determine what portion of its compensation for assuming the payment obligation has been "applied by the assignee for payment of damages" within the meaning of proposed new section 104(a)(6) of the Code. At a minimum, the bill could allow the third party to establish a reserve for its future liabilities, based on some type of actuarial assumptions, and exclude from gross income an amount equal to the reserve. As a matter of policy, the Treasury Department opposes any statutory provision that would effectively permit taxpayers other than insurance companies to take deductions for reserves for future liabilities of the type covered by H.R. 5470. Our experience with both life and casualty insurance companies indicates that the use of reserve accounting enables those taxpayers to overstate substantially their current deductions. This overstatement of deductions inevitably results from the use of conservative actuarial assumptions that are required by state regulatory agencies. In light of the inherent problems resulting from the use of actuarially determined reserves for tax purposes, it is inappropriate to extend these reserve accounting rules to additional taxpayers. Accordingly, the Treasury Department opposes this bill.

Moreover, the literal language of the bill would appear to allow the third party a greater benefit: it could defer the taxation of the entire profit it earns in the transaction until the amount of this profit can be determined with certainty. This would effectively allow the third party to defer all income from the transaction until its payment obligation is fully satisfied. Such extended deferral cannot be justified.

In addition to the problems just discussed, this bill points out a serious problem under current law relating to the taxation of damages for personal injuries that are paid periodically rather than in a lump sum. The problem arises from the fact that, under current law, the portions of periodic damage payments representing interest on a fund invested on the recipient's behalf are not taxed to the recipient so long as the invested funds are not actually or constructively received. This result follows regardless of whether the person liable for the damages arranges for a third party to assume the payment obligation.

As a matter of tax policy, we question whether the investment income element of periodic damage payments should be excluded from the recipient's gross income under section 104. If a defendant pays, let us say, $100,000 as damages for personal injuries to a plaintiff in a lump sum, that amount alone is excluded from the plaintiff's income. If the plaintiff invests the $100,000 directly, income earned on the investment generally will be taxed to the plaintiff. We believe that this is a problem that deserves further study.

In contrasts, if the defendant agress to invest the $100,000 and to make periodic damage payments to the plaintiff that include interest earned on the fund, the plaintiff can exclude from income the full amount of the periodic payments received and the interest may escape taxation entirely. If the damage payments are deductible by the defendant as business expenses, the interest income received by the defendant will be offset by deductions for the amounts paid to the plaintiff. If the defendant cannot deduct the damage payments as business expenses, he nevertheless can pay the $100,000 over to a third party that is in the business of distributing periodic damage payments, in which case the third party can offset the interest income earned on the invested funds by deducting the damage payments as made. In either case, the investment income on the $100,000 fund is untaxed.

The Treasury Department does not believe that the tax treatment of investment income earned on funds derived from a claim for personal injuries should depend on whether the damages are paid periodically or in a lump sum. In the absence of a Congressional decision to exclude from tax all income earned on investment or lump sum damage awards for personal injuries, the interest component of periodic damage payments should not escape taxation simply because a plaintiff has elected, in effect, to have the defendant or a third party invest the proceeds of a settlement for him.

Chairman STARK. Thank you, Buck.

I want to get back—I don't think you and I have disagreed in years—but going back to H.R. 5573, am I correct in suggesting that the cost-basis treatment suggested in my bill is the same as that which is now available for the donation of scientific equipment to universities?

Mr. CHAPOTON. That's correct.

Chairman STARK. Do you find any real difference in public policy of donating scientific equipment to universities than from donating computer equipment, peripheral equipment and software to grammar schools?

Do you agree, these both facilitate technological advancement into the modern age? The only difference is that one may be more fundamental than the other.

Do we fall apart in that area?

Mr. CHAPOTON. I think the principal difference I would see is, as I mentioned, that in the case of gifts to colleges and universities, this is a promotion of scientific research theme; this has a promotional aspect to it that I think——

Chairman STARK. I will deal with that separately. That is a fair assessment.

We are talking about raising the limit to 30 percent, that is one difference I see. The current limit of corporate profits that can be donated is 10 percent.

In a sense, we are trading off being able to do this quickly and encourage people that this is how we started the investment tax credit, lo, those many years ago.

This is a one-time deal to encourage investment in capital goods. By doing the 30 percent, we put a time limit on it. I would be willing to extend the time limit if it is not enough time, but the idea is to hurry to get this equipment into the schools where it is badly needed.

Now, I felt that was a reasonable tradeoff.

Mr. CHAPOTON. I think the time limit does have the desirable impact of limiting your potential loss, at the same time, we point out in the statement, and I have some concern about whether it limits the companies who might benefit.

Some, if they have a large inventory, will be able to do it, those that don't will not be able to.

Chairman STARK. To the extent that there is some equitable way to figure out when to start this, fine, either postpone the effective date or stretch the time on it, but that would probably increase the cost.

Let's deal with the promotional aspect. I think it makes good business sense for General Motors to donate automobiles to drivers training. If anybody thinks that General Motors does this out of the goodness of their heart, then they don't have any idea what really is happening. GM wants all these budding adolescents to learn how to use Dynaflow rather than Fordomatic.

I would think that other companies would do the same. Then we should encourage these other companies to do so.

Certainly it doesn't limit itself. Certainly it is not a dominated market. It is a hotly competitive market.

I would think that if you are right, then they are out of an awful lot of soft costs. That is a realistic loss opportunity.

It seems to me they are foregoing the gross profit potential and the wrath of their dealers and distribution organizations by recovering their hard costs.

I don't think they dispute that. But it is an attempt, if we are cutting back on aid to education to get some multiplier. If we assume that all these companies pay the full 46 percent of their income in taxes—which I doubt—then at best, we are getting a two, or three, for four bang.

If we appropriated the money, and went out in the market and bid on it, it would cost the taxpayers significantly more. Right?

Mr. Chapoton. I think the chances are it would unless the companies decided we had enough market advantage to sell at cost. That's correct; yes.

Chairman Stark. I suspect the marketing advantage is sort of like a book publisher wanting to give every kid a dictionary because some day they will be smart enough to read and buy books.

Compared to some of the other things we have spent taxpayers' money on, you must admit that this makes somewhat good sense; does it not?

Mr. Chapoton. Well, I think, Mr. Chairman, this comes down to a decision whether through the tax system you want to pick somebody up on a deal. It does amount, though, to the private administration of a grant program, the grant program under which private industry will sell this equipment to the Government at cost.

Chairman Stark. But no different than the research equipment that goes to universities?

Mr. Chapoton. Again, the promotional difference is the issue. I think it is significant. I think there are significant indirect benefits that flow to the company.

They probably do not exist in the other case.

Chairman Stark. I am sure the same thing exists. For instance, if you are training an incipient physician or Ph. D. in chemistry and they use somebody's gas chromatograph, when they go work for Standard Oil, don't you think they will be kindly disposed toward buying that type of equipment?

Mr. Chapoton. That may be so, but we are talking about a very large potential market that probably doesn't exist in the other case.

Chairman Stark. That is only because we are talking about a tremendous number of young people who need the education.

Mr. Chapoton. I don't want to be brought in distinguishing the other case. That is my point. Once you start down this road, there is another case out there that will be equally hard to distinguish.

You and I both know that as well.

Chairman STARK. And you know, I agree with that. The point is that nobody has been beating down my door or yours to say he wants to make a lot of donations.

Our deficit has not been widened because IBM has been giving away too many mainframe computers or somebody else has been giving away too many laser accelerators. They just are not flooding the market with them.

We have not had many people offer. You know, I am just maybe more cynical on this than you.

My first reaction is it might be stale inventory. But we have dealt with that. We will prevent someone from dumping last year's clunker on the market and getting a tax break.

I just am suggesting ways for you to go with the tide. For our own children, this is something that we can perhaps help.

I recognize your objections. I only wish that you had been more eloquent in defending the contribution of research equipment to universities, because then I would really have you trapped. Unfortunately, I don't.

On the codification, I gather what you are saying in 5470, is that you would not dismiss the possibility that the main thrust of 5470 could be accomplished by codifying the present rules in legislation, but you would want to look at them first?

Mr. CHAPOTON. That's correct.

Chairman STARK. That is all the questions I have.

Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

My questions relate to H.R. 4948. First, I want to thank the Treasury Department for supporting the legislation I have introduced.

Second, I would like to ask a question pertaining to its potential expansion. As you know my legislation would apply only to the pension plans that existed prior to June 27.

Mr. CHAPOTON. 1974; yes.

Mr. MATSUI. Whereas in your recommendation you want to expand it beyond that date and include all pension plans that were under a money purchase plan arrangement.

Mr. CHAPOTON. Let me qualify that. I have not gotten a revenue estimate on it and I do need that before we go with that.

Mr. MATSUI. Well, that is the reason I raise the point. One of the reasons we didn't put that provision for the inclusion of past June 1974 pension plans was the concern for the revenue estimates.

It is hoped that the Treasury Department could provide us with the revenue information prior to the markup. I would be happy to amend H.R. 4948 if the revenue estimates were such that it would be supported by Treasury.

Mr. CHAPOTON. We will do so.

Mr. MATSUI. Thank you.

Mr. CHAPOTON. Thank you, Mr. Chairman.

Chairman STARK. Our next witness is the Honorable James Shannon of Massachusetts, a member of the Ways and Means Committee.

STATEMENT OF HON. JAMES M. SHANNON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. **Shannon**. Thank you, Mr. Chairman.

Mr. Chairman, and Mr. Matsui, I guess I am going to be joined by Mr. Gore at some point, who is also going to testify, but with your permission, Mr. Chairman, I would like to read a short statement and then if you have any questions, fine.

Mr. Chairman, I have come here today to lend my support to H.R. 5573, the Technology Act of 1982.

You, Mr. Chairman, have been working, along with others of us in Congress, to help this country keep its lead in the high-technology field, and I am pleased to join you in this effort.

We know from unfortunate experience what happens when key sectors of our economy grow complacent, or fail to build strong plans for the future.

For example, America's advantage in cars and in steel has slipped enormously. This bill is one very practical and painless way of insuring that our advantage in high technology remains strong.

Supporting the long-term development of the American high-tech industry involves more than offering three cheers for computers. It involves taking very concrete steps.

The passage of this bill could literally result in there being a computer in tens of thousands of schools across America. In the struggle for high-tech supremacy, one of our Nation's truly dangerous shortcomings has to do with our educational system.

Unfortunately, it is failing to develop the scientific literacy of our students.

The quality of our scientific education programs has been declining. Young American students are less and less scientifically skilled in comparison to our foreign competitors.

They now rank only fourth worldwide—behind Russia, behind Germany, and behind Japan. Even worse, it's been estimated that by 1985, there will be a shortage of 100,000 engineers in the electronic industry.

Why is this happening? A big part of the immediate problem is that many of our schools simply can't afford the technology that's required if we're to have a computer-literate society in the future.

This bill would change that. For a brief, 1-year period, it would provide companies an incentive to give their computer products to elementary and secondary schools.

Yes—objections have been raised. The administration objects to the basis-plus-one-half appreciation rule. But this bill merely extends to elementary and secondary schools provisions in the 1981 Tax Act which allowed deductions for donations of scientific equipment to colleges and universities.

I think we can all agree that we do not want to make such deductions a matter of common practice. But there are times when a dramatic need requires a very specific and well-focused response. And that is the kind of situation we are in when it comes to high technology and high-technology education.

Let's not pass up a clear-sighted solution simply to adhere to a principle which, in this particular instance, could end up doing us more harm than good.

Some say the approach taken in this bill is too expensive. But if we agree that as a matter of national policy we do want computers in our schools, a tax incentive like this is the cheapest and quickest way to do it.

The effective cost of providing this tax incentive is much less than the money that would be spent by school systems if they were to go out into the retail market and buy computers—if they could afford to buy them at all. And it would never happen as fast as it would under this bill.

The administration has also claimed that there is no reason why this treatment should be accorded to this type of equipment—not when other worthy educational equipment such as books, projectors, or similar education materials would not qualify for as large a deduction.

But this argument fails once again to take into account the fundamental reality which this bill addresses. Across the country, we are seeing school cutbacks. They are occurring at a time when our need for quality high-tech education is becoming painfully apparent.

If we are to meet the technological and economic challenges of the future, then computer education must recieve a special stimulus. And it must receive it now.

Those of us supporting this bill do so not because we are interested in handing out tax breaks. We support it because we believe that this bill is a careful, cost-effective response to a very particular, acute problem. It is a perfect example of how Government can work with private industry to solve such problems.

Naturally, we are willing to work with the Treasury and with others to make sure that the final version of the Technology Act of 1982 is fair and effective.

If any amendments or additions to the bill are needed for this purpose, we would be happy to hear them and to consider incorporating them into the bill before it is reported out by the Ways and Means Committee.

But let's not lose sight of the underlying objective: Supporting America's technology future. Passage of H.R. 5573 would serve that objective quickly, efficiently and inexpensively. This is the way we should be using tax incentives.

I hope the members of this subcommittee will join me in giving it their support.

Thank you, Mr. Chairman.

Chairman **Stark**. Thank you, Mr. Shannon.

I am pleased to welcome our colleague, Congressman Al Gore from Tennessee.

Al, proceed.

STATEMENT OF HON. ALBERT GORE, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TENNESSEE

Mr. **Gore**. Thank you very much, Mr. Chairman. I am pleased to be able to offer my testimony and strong support for the legislation you are considering today and I want to commend you in particular for bringing this issue to the forefront.

I bring a special interest in this legislation as chairman of the Congressional Clearing House on the Future. We have been looking at the subject of computer literacy for the past few years and recently, this spring, sponsored a special computer literacy course for Members of Congress.

What has become crystal clear during these informal examinations is that computer literacy is becoming a necessary tool as our Nation and the world moves into a new era of high technology—technology developed and deployed not only for industry, defense, and government, but for every American of every age.

As recently as this past weekend, the National Science Foundation released the Institute for the Future report on the implications of new electronic information technology on our lives in the coming years.

One of the points made in the study is that we will all be living and learning with computers. It follows that those of us who are prepared to deal with this new technology in our daily lives will be the first to prosper with it.

In fact, the ability to incorporate basic computer literacy into the skills of our young people could be the difference between a generation of occupations misfits or a rapid growth in productivity at all skill levels in our economy.

As they enter the job market, our high school students are the most vulnerable to inadequacy in skills. We are told that millions of jobs will be lost in manufacturing and other labor sectors in the coming two decades—all because of rapid technological developments bringing about new productivity gains.

We also know that there is another side to that scale—millions of jobs will be created in the service sector and in new apsects of older industries, most incorporating sophisticated new computer and communications technology.

We must be sure that the high school students of today do not become a lost generation. According to the late Margaret Mead:

> Our schools must be prepared to instruct students in what no one dreamed of yesterday * * * what has not been discovered today * * * but what some people must know tomorow. Educational institutions must be fully prepared to lead the way * * * for the future strength of our Nation rests with the effectiveness of our learning institutions.

I know that that is what your bill is all about. We must remember that our high school students are able to pursue an elective education only so far—often only as far as a school's resources.

In the case of computer hardware and instruction, those resources are nil. We occasionally read about an exciting new effort by a progressive—and usually affluent—high school to develop a computer-oriented curriculum. I wish I could tell you today that such programs abound in my State of Tennessee.

Unfortunately, among the 295 public secondary schools with more than 260,000 students, there are no more than a small handful of courses in computer literacy, much less actual hands-on computer hardware opportunities.

Albert Shanker, president of the American Federation of Teachers, made an incisive observation on this issue during a recent AFL-CIO workshop on the impact of computer-based technology on the global work force:

Heretofore, people who attended high school or college knew that they had acquired a certain set of skills that would be good for the rest of their lives.

Now, technological change is so rapid that it is unlikely that people will get a single education or set of skills which will see them all the way through.

Certainly, many of those students in my State and yours, Mr. Chairman, will find a way to acquire computer skills even if they do not get them in high school.

However, the millions of teenagers who will not be able to pick and choose such post-secondary instruction will be those who need these skills the most, because they are the ones who are the most vulnerable to the kinds of disastrous economic swings we are now witnessing, and which are beginning to get much worse.

The result has been skyrocketing unemployment with devastating implications for our society. We have a whole set of occupations losing jobs and people looking for jobs and we have in the want ads companies screaming for more computer programers, more electrical engineers, so we have masses of unemployed people with old skills and many new job openings for people without the skills needed.

Now, the common language in a lot of these new jobs has to do with computer literacy.

What happens to those young men and women when the economy swings upward, but the jobs they traditionally fill are now gone?

Our secondary schools and educational planners recognize this problem, and they are capable of planning for it, but their hands are often tied by budgetary constraints.

The purchase of a $2,000 computer and maintaining the instructor to use it is simply out of reach for most public schools, certainly those in my district and through the State of Tennessee.

The modest tax deduction allowed in H.R. 5573 may be one answer—and I believe it is—a very limited impact on revenues with a clear long-range benefit for schools throughout the Nation and for our society.

We now know that the reluctance to utilize computer technology is based mostly on unfamiliarity with the hardware, what it can do and cannot do, and how it can increase our performance and productivity.

While many of us now in the workplace may balk at major changes in the way we do our jobs, certainly our children are poised to accept and utilize this technology beyond an occasional game of Pac-Man.

We are constantly made aware of our need to catch up with the Japanese, through enhanced productivity methods and newer technology. We have all heard that litany.

That catch-up process must begin with our fundamental education techniques and curriculum resources.

This Congress has already extended tax incentives to stimulate donations of computer hardware for research purposes. I suggest that the payoff in long-term increased scientific achievement might be greater if our Nation's secondary schools and perhaps our teachers' colleges and children's museums that instruct children and other institutions, were able to obtain the hardware necessary to begin basic instruction.

The Treasury Department has criticized this bill as being too generous to a specific industry and fraught with potential abuses.

I believe you have taken proper steps in drafting your bill to prevent abuses, such as dumping obsolete equipment. After hearing all sides of the issue, you may have further improvements. No doubt you will.

Most importantly, the revenue losses under even the most optimistic projects of donations are a small price to pay for the monumental leap in the computer skills we know will be so vital as our youth enter a dramatically changing workplace now and in years to come.

I appreciate this opportunity to add my thoughts on this important initiative and I am ready to do everything I can to help you further this very worthy objective.

Thank you, Mr. Chairman.

Chairman **Stark**. Thank you, Al.

I know of the work you have done in the Clearing House of the Future, and with the Children's Capitol City Museum, and your interest in innovative technical processes and work in your home State of bringing some of the creative work that has been done by Japanese industry to the attention of both labor and management in Tennessee.

So we are particularly flattered to have you endorsing this legislation, and your colleague, Mr. Shannon, who is a leader on this committee.

You carry the torch for high-technology industry and, indeed, for having that lead the way to pull some pretty prosaic industries out of the doldrums.

It is only as our newer industries lead the way that some of the older industries can retool and retrain workers, and Jim has done a lot of work in that area, so we appreciate both of you taking the time to come before the committee.

Mr. Matsui.

Mr. **Matsui**. Thank you, Mr. Chairman.

At this time, I would like to thank Mr. Gore and Mr. Shannon for their testimony today. Mr. Gore has held a number of hearings regarding the French perspective on the high-technology issue, and that has been helpful to the dialog we have had in this country. Mr. Shannon has been one of the leaders, maybe the leader, regarding the high-technology tax credit that we passed last year.

So I would like to commend both of them for their testimony and at this time, Mr. Chairman, I would like to again commend you for the fact you have introduced this legislation. You certainly have the support of this member of the subcommittee.

Thank you.

Chairman **Stark**. Thank you very much. I wanted to ask both of the witnesses, if you each remember the time in the ERTA legislation we were talking about the tax credit for high-technology contributions to universities.

Did you ever hear the administration raise objection to that provision?

Mr. **Shannon**. I think, Mr. Chairman, if I remember correctly, they were quite boastful of the fact that when the final Republican position, administration position, was drafted prior to the vote in the House of Representatives, they had included some of those provisions in their substitute.

If they had reservations about the provisions at the front end when you and I first started talking about them, by the time the vote took place on the floor of the House of Representatives, it was my understanding that they were taking credit for them.

So I have some difficulty understanding why they have such serious policy objections to expanding that concept this year.

Chairman STARK. I would hate to think it was just because of the way it was introduced. But, in all honesty, they objected on the other side when it was introduced in the other body by a Republican. So, they are being consistently inconsistent.

Mr. SHANNON. Mr. Chairman, if I could, since you did make a reference to rule 128, let me say I have not been beleaguered with phone calls from those constituent companies urging me to support this bill for a simple and very explainable reason; that is, this bill will end up costing them a lot of money and the whole computer industry a lot of money from charitable contributions to schools.

I think the beauty of this bill is that a real public service would be used here. I think, as Mr. Jobs will probably testify later on, this is not going to be a free lunch for the computer industry at all. It is going to be something that is of cost effectiveness in the short run. I think that will help strengthen that industry for the United States.

Mr. GORE. I don't have any computer manufacturers in my district and have no pressures. I am here because I think your bill is an excellent one. In the proceedings of the clearinghouse on the future we have identified this area for a long time now as an area where America will either continue to be a continuing leader or will fall quickly behind.

The computer revolution is going to have impact on the world, the economy, that is on the same order of magnitude as the industrial revolution, perhaps exceeding it, except it won't take place over a 200 to 250 year period. It will take place in our lifetimes, and we need to equip our children in the next generation to be in the forefront.

I had a hearing 2 weeks ago in the Science and Technology Committee on robotics. We looked at the impact on manufacturing jobs is likely to be from the marriage of computer chips and intelligent machines to the new robot machinery that is being put in our manufacturing facilities.

The conservative publications, like Business Week, predicted out of the 28 million manufacturing jobs in the United States today, 25 million of them are likely to be replaced by machines shortly after the turn of the century.

Well, now, that is a pretty incredible prediction from Business Week magazine, and in the services sector you are seeing the introduction of the computers there as well. These jobs in programing with computers and robots and all kinds of new jobs that related to those tasks are opening up, so it just is a matter of whether we are going to do it sooner or later.

The consequences of doing it later are unthinkable. We have to do it sooner. Your bill is this opportunity to get skills into schools right away. You see that opportunity, instead of having a very large, unwieldy Government effort. I could see a very rational debate in this country about an expensive U.S. Government program, to use appropriated funds, and purchase computers with standards and a big, complex Government program to accomplish this same result.

I can see a very rational debate about that. Instead, you have a very simple, elegant way to do it quickly and easily and accomplish the same result. I think it is such an enormous need and terrific opportunity that Congress would be short-sighted not to pass this.

Chairman STARK. I thank you. I must say that if the legislation gets signed into law and the Apple Computer Co. buys an oil company, I would be so surprised that I would switch parties. Speaking of which, I welcome my colleague, Mr. Vander Jagt.

I want to thank our colleagues for their participation.

I call our first panel: Steven Jobs, chairman of the board of Apple Computer, and Mr. Emery Rogers, chairman of the national grants review board of the Hewlett-Packard Co.

Gentlemen, I will call you in the order you appear on the witness list. I appreciate your being here. We have the complete text of your testimony, which, without objection, will be made part of the record. Having said that, I would also say that you may summarize your testimony. We all have had a chance to read it, and we can get into a discussion following your summary.

Mr. Jobs, do you want to start?

STATEMENT OF STEVEN P. JOBS, CHAIRMAN OF THE BOARD, APPLE COMPUTER, INC.

Mr. JOBS. Rather than go through all of the particulars of the specific bill today, what I thought you could best make use of my time for is to cover some of the objections and concerns that have been raised and some of our thoughts and responses to some of those concerns. I would like to talk about six of them today:

The first one is a concern that this is going to be a free ride for Apple.

The second one is that this is just a brilliant Apple marketing scheme.

The third is that this is a bill that is really good for Apple's benefit only.

A fourth is that manufacturers could abuse this legislation to unload excess and/or obsolete inventory?

The fifth is the whole training issue, are we just going to dump 100,000 computers on the schools and walk away?

The sixth is a subtle issue; that is, is any bill which benefits the private sector bad inherently.

Let me go through this one by one.

The free ride for Apple. I would just like to sort of dispel a rumor. Mr. Chapoton used the phrase "wholly federally funded program." We are not saying that. We estimate the incremental cost of this legislation, assuming we put one computer in every accredited school in the United States, is approximately $40 million incremental dollars, of which we are proposing that the private sector pony up about $10 to $12 million of that, and the public sector, Government, fund it to the tune of about $30 million.

We feel that is about a 75 percent/25 percent sharing. We also feel through this partnership, what would the retail value——

Chairman STARK. What would the retail value of that be, figuring schools may buy in quantity?

Mr. JOBS. We feel it will exceed a quarter of a billion dollars.

Chairman STARK. $250 million?

Mr. JOBS. Yes; as a result of approximately a $27 million contribution by the Government and approximately a $10 million contribution by the private sector, so it is an approximate 10-to-1 leverage. We don't feel it is a free ride for Apple. I will cover some other points relevant to this issue later.

The second concern was that this was just another brilliant Apple marketing scheme. We are good at marketing our ideas. We were a major catalyst in the creation of the personal computer industry, which is now over $5 billion a year, and we do sell a lot of computers to schools today, over 50,000 computers this year.

If we were just interested in increasing our short-term sales into the education marketplace, we could take the $10 million that this program could potentially cost us and plow that into advertising and other merchandising forms that would give us far more short-term sales than this program will give us.

The enlightened self-interest that we do have comes from our belief that a generation of kids growing up knowing how to drive automobiles are going to buy a lot more automobiles when it grows up.

It is a gamble we are willing to take. If we were interested in short-term sales into the marketplace, we could be more efficient.

The third concern is that the bill is good for Apple's benefit only. I think our industry has been characterized as probably the most competitive industry in the free world. We have over 50 competitors. Most of them are multibillion-dollar companies. To name a few: IBM, Hewlett-Packard, Xerox, Tandy, and, of course, Japan.

Apple is in general the smallest of those competitors. We will do about $600 million in sales this year, and by no means are we in a position of domination of the industry from a financial or resource point of view.

In addition to that, there will be over 1.5 million personal computers shipped in 1982, far more than that in 1983, so the 100,000 or 103,000 units that might flow into these schools is a small percentage. So, I don't think Apple has any advantage over any competitors.

We are also proposing that the bill take effect next February, which would give everybody significant advance notice to prepare and we, of course, have not built up any inventory in anticipation of this program at all.

The fourth—concerns that manufacturers could abuse this legislation to unload excess or obsolete inventory. The bill, as it is drafted today, simply copies the university legislation provision that was passed last year, which states that the equipment must be manufactured within the last 2 years.

We propose shortening that to a 180-day limit which would insure no abuse and also insure that schools receive state-of-the-art equipment. If the bill takes effect next February, this would mean that any equipment manufactured to date could not be contributed and take the liberalized deduction.

The fifth is the training issue, are we going to dump 100,000 computers on schools and walk away.

First of all, we have over 3,000 letters from 3,000 schools asking to be put on the list for contribution of our equipment. I think there is a tremendous desire coming from that end of the spectrum.

The second thing I would like to point out is the experience of the State of Minnesota.

The State of Minnesota already has over 4,000 personal computers in the State and every high school student in that State has had a course in computer literacy. In addition to that, they have written over 400 programs in computer literacy and computer aided instruction, which they are attempting to sell to some of the other States.

All we want to do is simply help the other States duplicate the success of Minnesota. We have a case we can point to where the training issues have been solved. So, I think the real key thing is to duplicate that success.

The last point is more of a subtle one; that any bill which benefits the private sector should be looked at with a tremendous degree of suspicion. We believe that. I think this bill has been scrutinized to a high degree. We also believe the computer is really at the epicenter of the information and technical revolution which has begun in America and was talked about here today.

The kids coming out of Minnesota and other places like Minnesota which have had the foresight and affluence to equip their students with equipment so they can learn computer literacy will have a better chance getting jobs than the noncomputer literate kids coming out of school 5 years from now.

The partnership, the contribution of $27 million by the public sector and $10 million by the private sector will result in a quarter billion dollar benefit for the kids of tomorrow.

As Congressman Gore said, we feel strongly that Congress would be crazy not to take us up on this.

Chairman STARK. Thank you.

[The prepared statement follows:]

STATEMENT OF STEVEN P. JOBS, CHAIRMAN OF THE BOARD, APPLE COMPUTER, INC.

H.R. 5573 has been referred to by some as the Apple Bill. We are happy to have our name linked with this legislation and, if it passes, Apple has publicly pledged to contribute tens of thousands of computers to elementary and secondary schools.

Unfortunately, a number of spurious issues have been raised by some who appear not to have taken the time to understand this Bill or evaluate the benefits, as well as the costs, of Apple's commitment. The time has come to dispel these issues because they tend to make one forget that what we are talking about is insuring that every school in the United States has a computer.

First, let me underscore the fact that passage of this Bill in no sense means a free ride for Apple. In fact, our program will be of substantial cost to our company, or any other that chooses to participate. The tax savings from the liberalized charitable deduction included in H.R. 5573 applies to inventoriable costs only. It would allow us to recover up to 92 percent of our direct costs (direct labor, materials, and factory overhead) but would not affect indirect costs—which, even after taxes, amount to a monumental commitment of company resources.

We would incur and absorb the cost of handling, packing, shipping and installing the equipment; the cost of providing our standard warranty service; the cost of channeling millions of dollars in company funds to buy the parts and pay for the labor we must use to manufacture the contributed computers; and, finally, the cost of administering a vast, nationwide program.

Our most conservative estimates show that, on an after-tax basis, Apple's unrecovered cost will be at least $100 per computer or $1 million for every 10,000 computers we donate. Looked at another way, if Apple gave a computer to each of the more than 100,000 schools in the country, our after-tax expense would total over $10 million. Industry analysts have estimated that Apple will earn $50-60 million in fiscal 1982, ending September 30. As you see, $10 million could represent 20 percent of our total earnings for this year * * * hardly a free ride.

Second, we keep hearing suggestions that Apple wants to see H.R. 5573 passed so that we can unload excess and obsolete inventory. This is untrue. Our present inventory levels are where they should be. But, to remove any doubt, we have recommended that the Bill contain a provision limiting qualified contributions to products which are no more than six months old. We urge you to adopt this amendment to make certain that no company can avail itself of the Bill to dispose of unsaleable or slow moving products at Government expense.

Third, some have argued that H.R. 5573 is really a marketing scheme paid for by the Government. If this were true, and the Bill in fact were a bonanza for computer companies, why hasn't our competition jumped on the bandwagon? The answer, as noted earlier, is that the program we propose will cost any participating company a tremendous amount of money. Apple may ultimately derive some marketing benefit when today's secondary and elementary school children are ready to purchase computers. But if increased sales were our primary goal, we would be far more certain of an immediate reward if we ploughed the anticipated cost of this contribution program into advertising.

Fourth, is the suggestion that H.R. 5573 is designed to benefit Apple only, or that only Apple has the capability to act if it becomes law. This is not the case. The Bill is broadly drawn, so that any manufacturer of presonal computers can qualify to make donations under it. As for the notion that we are prepared to move instantly while others are not, we have asked that H.R. 5573 be amended to become effective February 1, 1983. This will not only put all companies on an equal footing, but will give Apple the lead-time it needs to fulfill its commitment. We cannot act instantly; our management would be incompetent if we expanded production now before this Bill passes. Apple is charitable but not self-destructive.

We do not seek a bill which excludes our competition. We ask them to join with us in this incredibly important undertaking. Apple believes it is of fundamental importance for every elementary and secondary school in the United States to receive a computer, but the computer doesn't have to be an Apple. We ask Tandy to join with us; we ask IBM, Digital Equipment, Xerox and Commodore to join with us. If these and other micro-computer manufacturers will undertake their share of the responsibility to insure computer literacy in this country, Apple's goal will be achieved at a much lower cost to our company.

This brings me to what is truly important about H.R. 5573. While the Bill may someday benefit any company which donates computers under its provisions, the important point is that the Bill is clearly good for the United States. Hopefully we have not come to the point in this country where any law that may be even remotely good for business automatically is perceived as bad for the country. In the area of technology particularly, that perception is fatal to the long term well being of America.

We are now in the midst of a revolution that is of the same magnitude and power as the industrial revolution of the 19th Century. It is changing our society, our skills and the character of employment in the United States.

This revolution is driven by advances in microelectronics, transforming the contemporary world from an industrial to an information society. At its heart is the electronic computer—invented in America 36 years ago and destined to become as essential and pervasive a tool in the late 1980s a the calculator became in the 1970s.

To maintain America's technological leadership, we must begin training students—from the elementary through the secondary grades—in today's computer technology. If we do not, we risk producing a generation of Americans who will be unfit for the jobs that will be available five to ten years from now and who will be both noncompetitive and nonliterate in the information society now evolving.

The trends are clear. Information activities contribute a larger share of the Gross National Product than manufacturing and agriculture combined. About 75 percent of the U.S. work force falls in the service sector and about two-thirds of the service sector is concerned with information. In short, approximately 50 percent of the work force and GNP are now linked to the information industries.

The Department of Labor forecasts that the computer industry will be the fastest growing segment of our economy in the 1980s. Computer-related jobs dominate five of the six categories of employment which are expected to expand most rapidly in this decade. While the need for scientists will be great, the most pressing requirement will be for "knowledge workers"—engineering technicians, professionals, managers, clerks and all who apply computer-communications knowledge in business, industry and government.

Although we are in the formative stage of the information revolution, we can predict the skills that an individual will need to succeed. Computer literacy will become a prerequisite for employment in numerous jobs. Employees in general will require more technological awareness than their counterparts today. Yet, little is being done today to prepare these future employees for the coming work environment.

The state of technological education in the United States is disturbing:

In California, elementary school students averaging 44 minutes a week on science. Only one-third of the nation's high school offers more than one year of mathematics or science. Only one-sixth of all high school graduates in the U.S. has taken a junior and senior level math and science course. Only fifteen percent of the male and seven percent of the female students in California takes three or more years of high school science. Achievement scores nationwide have declined since the 1960s. In 1979, mean SAT scores were 472 for the verbal and 467 for mathematical aptitude, out of a possible 800, down from the 500 for both categories which had previously been established as the standardized average. The number of electrical engineering graduates in the U.S. has remained the same for the past 10 years, despite a tremendous growth in the electronics industry.

These facts are even more distressing in light of our educational performance compared to that of other countries. The United States has now dropped to fourth in scientific literacy—behind Russia, Germany and Japan. Russia graduates three times as many engineers as we do. Japan, whose population is half that of the U.S., graduates more electrical engineers ever year than we do.

The results of this decline are expressed in a growing shortage of engineers and technicians in this country. The American Electronics Association projects that by 1985 there will be a deficit of 100,000 engineers in the electronics industry. The current scarcity of trained technical personnel in th Santa Clara Valley—known as Silicon Valley because of its concentration of microelectronics firms—is well documented.

The fact is that the gigantic achievements of Silicon Valley, as well as other centers of high technology in America, had their roots in the investment made by prior generations in what I regard as "human capital." Our failure to continue that investment may thwart us from building on the technological foundation that has been laid.

We are not answering this need. In California, for instance, 19 percent of the school districts have made cuts in science programs and 12 percent have reduced mathematics instruction since Proposition 13. One out of every four school districts in California has cut back vocational education and industrial arts courses.

An important missing ingredient is money. Many schools nationwide have been forced by budget constraints to reduce equipment acquisition to an austerity level. The lack of new equipment may soon impair the ability of our schools to offer state-of-the-art technology training. In the last ten years, for example, shortages of equipment and supplies have cut by more than half the exposure of American students to any form of laboratory experience—even of those students who take science.

In particular, equipment shortages undermine the ability of our schools to teach computer literacy. Computer literacy—a key to proficiency in the information society—has become recognized as the legitimate concern of the educational system. The State of Minnesota, to cite an example, requires all of its high school graduates to demonstrate skill and familiarity with computers.

We believe H.R. 5573, The Technology Education Act of 1982, is an excellent Congressional initiative to address these problems. It is of particular interest to Apple because it provides a means whereby the private sector can participate directly in improving technology education.

This Act offers a liberalized charitable contribution deduction for donations of computers to elementary and secondary schools. This is not a revolutionary concept. The Internal Revenue Code already contains such a provision (section 170(e)(4)) for contributions of scientific equipment to colleges and universities. H.R. 5573 does nothing more than extend this existing concept to elementary and secondary schools, the level where computer education must be made available. Leaving this to the colleges in today's environment is equivalent to leaving the teaching of English grammar and arithmetic to the colleges.

We do not believe, of course, that the donation of computer equipment to schools represents an educational panacea. We need teachers to teach computer literacy and the schools to adapt and endorse computer education programs. We realize there is a need to integrate computers into schools. We have some thoughts on how this might be done, but clearly much work and analysis has to be given to the subject. Several educational groups and educators have expressed interest in working with us to insure that the computer will be used, and not sit and collect dust.

We believe that passage of H.R. 5573 can have an immediate and profound impact on our school systems. The immediate impact will be most significant in the poorer school districts where budget constraints have been most severely felt. Students in such districts face a clear competitive disadvantage in the job market of the future, compared to students from areas of affluence. H.R. 5573 will have long-range importance both in terms of America's technological strength and the ability of our people to find and competently hold jobs in the society which is now emerging. The computer is at the epicenter of the information revolution, and computer literacy in the late 1980s and beyond will be virtually as fundamental a skill as verbal literacy is today.

Let us begin to meet this national challenge by enactment of the Technology Education Act of 1982.

Chairman Stark. Mr. Rogers?

STATEMENT OF EMERY H. ROGERS, CHAIRMAN, NATIONAL GRANTS REVIEW BOARD, HEWLETT-PACKARD CO.

Mr. Rogers. My name is Emery Rogers, and I am chairman of the national grants review board of Hewlett-Packard. As such, I coordinate all of H-P's philanthropy, wherever it may occur.

To give you a few points of reference, H-P has corporate headquarters in Palo Alto, Calif., and is a designer and manufacturer of electronic equipment for measurement, computation, and analysis. H-P makes about 4,000 products, sold into the world of science, engineering, business, industry, medicine, and education.

H-P had sales of $3.4 billon in 1981, and as such it is the 110th largest company on the most recent Fortune 500 list. In addition H-P is about the 30th largest corporate giver in America, and about the 20th largest exporter.

Our grants, both cash and equipment, in 1981 were over $5 million, taking equipment at cost. If the equipment is valued at its market price, H-P gave $10 million away. We are going to increase that number by 50 percent in 1982, one reason for which will come up in just a moment.

I am very pleased to be here to support the idea of extending the tax deduction under section 170(e)(4) of the Internal Revenue Code to primary and secondary education. There is an enormous U.S. need for science and technical education, as a number of previous speakers pointed out. There is also a great need for teachers. This tax incentive which we are discussing today could encourage industry to jump in much more strongly to help meet these needs.

We believe the existing rule under section 170(e)(4) for determining tax deductions, cost plus half of the appreciation up to a maximum of twice cost, is entirely satisfactory. Let me just give you a very concrete example of what that deduction formula means to recipients in the recent few months following the August 1981 passage of the Economic Recovery Tax Act.

H-P made a calculation of the tax savings which would occur as a result of its equipment giving, and we found out that we would be able to save about $1 million. We made a decision to add these savings to our philanthropic program, instead of plowing it back into the business.

The net result is we extended our equipment grants program in a major way as a result of a simple tax incentive. Many more universities profited from that. We do believe that the existing formula is an effective incentive. We would not like to have the tax decuction increased to market price or anything of that sort because there have been problems in the past with such an approach that we don't think should be repeated.

Let me give you a brief summary of how H-P conducts its philanthropy, including grants of equipment.

In 1982 H-P will give away about $15 million. Our entire philanthropic program will consist of cash grants of $3 million and equipment grants of $4 million at cost, but that equipment has a value to recipients of $12 million.

We have three categories of giving at Hewlett-Packard: National, community, and academia. We conduct our philanthropy at H-P by what I would call the employee involvement system. We have hundreds, maybe thousands, of employees all over the country who contribute their opinions to philanthropic decisions and take enormous pride in gifts that H-P makes, whether on a community level or by means of equipment to a university. This differs from an oligarcial system where one person decides the disposition of grants.

Let me give you two national examples of grants from Hewlett-Packard. If you listen to National Public Radio, you will hear that the Hewlett-Packard Co. supports all of its science reporting, in partnership with the National Science Foundation.

We think literacy in science is crucial to this country. We lend smart people at H-P to minority colleges and to a high school or two to help those organizations generate and implement science and engineering courses.

These employees eventually return to the company after about 1 year.

Our community programs are conducted by local employees in the immediate vicinity of our numerous facilities, and take the form of cash and matching of gifts.

Equipment to academia is the dominant feature of our philanthrophic program and has been for many years. The recipients are U.S. universities and colleges, a few selected high schools, as well as hospitals and other organizations of this sort.

We are currently giving equipment to about 25 high schools, where the leverage for the recipient is significant, as you can well imagine.

There are no strings attached to our equipment grants. I am sure that many of Apple's better people have been trained on Hewlett-Packard granted equipment at many colleges and universities.

I do want to point out that there are many costs in equipment granting. It is a very special form of philanthropy and one must spend a lot of time making sure that recipients know what they are getting into when they receive complex devices.

Literally thousands of hours are spent by our employees worldwide to make sure that equipment grants are wisely implemented. There is what I would call a "10 times" rule. It is 10 times as difticult to give away a piece of highly sophisticated technological equipment worth *x* dollars as it is to write out a check for *x* dollars.

There must be several reasons for this. One is, of course, that the granting company must carefully examine the potential recipient's capability of coping with an eventual gift, if approved. Second, the tax deductibility provisions have not been very generous and therefore there have not been many companies that have been induced to get involved in this complex area. We are among a handful of companies that have been giving equipment. I don't think that the problem of the evaluation of recipients will ever go away when technological equipment is involved, but if we can get some more tax incentives, I am sure equipment grants will be greatly expanded.

Therefore, we recommend that the expanded tax incentives under section 170(e)(4) be extended to elementary and secondary schools. We know that providing equipment to these schools will be a sure escape path from deprived conditions for many youngsters.

We have just observed a situation in our own neighborhood where H-P made a grant of 10 personal computers to a high school in an area with largely minority enrollments. It is exciting to hear those kids after they have stepped into that program and have developed a sense of self-confidence. They will get the summer jobs; they are going to be able to work at Apple or Hewlett-Packard or some other computer oriented company; and equipped with useful knowledge they can step out of the frustration loop. These young people have confidence in themselves and, furthermore, they find that nobody at the school teases them. There is a widespread desire to get into these programs.

I am quite convinced, as are a number of university presidents, that just as you can't graduate from college or a university without passing English A, you are going to have to pass Computer A in the future. I have already seen colleges take that step.

I have just read an editorial in Science magazine which says that because of the deplorable state of equipment in many of the teaching situations in America, the students are going to be trained as if they had graduated from a school in a developing country.

I got the shock of my life the other day when I visited my old department, the Stanford University's Physics Department, and found that its teaching labs were still heavily laced with vacuum tube devices.

One aspect of the bill being considered by this subcommittee that we feel is inappropriate is the 1-year sunset provision. I want to give several reasons for that.

First, computers and the equipment used in scientific and technical fields become more sophisticated at ever-increasing rates, and the need of our schools for new and ever more sophisticated scientific equipment will continue for the foreseeable future, much beyond the duration of any sunset period. We are convinced that this condition is a movie and not a still picture.

Second, we believe that the need is much greater than could ever possibly be met in one or several years, even assuming substantial increases in school budgets, as well as grants by equipment manufacturers.

Third, the educational process requires teachers, textbooks, and curriculum in addition to computers and scientific equipment. Those will not be developed rapidly.

Our fourth reason is that the long experience of Hewlett-Packard in making equipment grants has shown us that corporations that are not currently making equipment grants may require several years to learn to make such grants effectively.

In summary, Hewlett-Packard Co. is delighted that the subcommittee is considering these new opportunities, and we believe this legislation should get favorable consideration.

I would like to close with three main points. They are based on our experience and observations:

First, there is a desperate national need for literacy in science and computers. The reasons are very simple. The jobs are there, and we can't fill them. Exports of technologically advanced products are also a crucial matter. I don't need to tell you that the big contributors to the positive side of the balance of payments in this country are agriculture and technological devices. And, agriculture is so successful in the United States because of its technological underpinnings. It will be a serious matter if we lose this crucial edge.

Second, we would like to encourage many more companies to engage in the philanthoropic granting of equipment. This would also have the side effect of reducing any accusation that only one company was benefiting by the bill before the subcommittee.

Third, it must be recognized that considerable time is required to learn how to give equipment wisely.

There is a real conclusion in all of this, as I see it. We see no revenue loss to the Government if companies begin giving equipment who never gave before. The biggest revenue loss of all will occur if we let the technological ship go down in this country. Therefore, I would like to see "high technology" companies not only compete in selling products, but also compete in philanthropy to see who can do the best job of keeping the ship afloat.

[The statement of Mr. Rogers follows:]

STATEMENT OF EMERY H. ROGERS, CHAIRMAN, NATIONAL GRANTS REVIEW BOARD, HEWLETT-PACKARD CO.

INTRODUCTION

Mr. chairman and members of the subcommittee, my name is Emery H. Rogers. I am the chairman of the Hewlett-Packard Company National Grants Review Board. In this capacity I coordinate the philanthropic programs of Hewlett-Packard Company.

Hewlett-Packard Company is a designer and manufacturer of precision electronic equipment for measurement, computation, and analysis. The Company makes more than 4,000 products, which are sold worldwide and have broad application in the field of science, engineering, business, industry, medicine, and education.

During its fiscal year ending 31 October 1981, Hewlett-Packard Company had worldwide sales of $3.4 billion and after-tax profits of $312 million. During fiscal year 1981, Hewlett-Packard Company made charitable contributions in the amount of $10.0 million, which consisted of cash grants of $2.5 million and equipment grants at an inventory cost of $2.5 million. The value of the equipment to grantees was $7.5 million.

Ranked 110th in size among the current Fortune 500 companies, Hewlett-Packard Company is currently about the 30th largest corporate giver in the United States, and ranks among the very largest grantors of equipment.

Another statistic of interest from the Fortune magazine of last August is that Hewlett-Packard Company is the 19th largest exporter from the United States.

SUMMARY

I am pleased to have the opportunity to present to the Subcommittee the views of Hewlett-Packard Company concerning the federal income tax deduction for charitable contributions of computers and other scientific equipment. It is our view that the existing federal income tax incentives for giving scientific equipment to colleges and universities for research or research training should be extended to all levels of educational institutions and to any direct use in the education of students in the United States.

To allow the United States to maintain a leadership position in science and technology, our educational institutions must produce well-trained scientists, engineers, and technicians. In adapting to an increasingly sophisticated technological environment, however, great burdens are being placed upon our educational institutions. Our schools have a great need for teachers who are skilled in the new, advanced technical disciplines.

In addition, in order to maintain and improve the quality of scientific and technical education in the United States, it is also necessary that state-of-the-art scientific equipment, instruments, and computers be available to our students, both to train our future technicians, as well as to encourage computer and science literacy.

By expanding existing tax incentives, Congress can encourage industry to share the costs of the new equipment that is needed by our high schools, community colleges, and universities.

HEWLETT-PACKARD CO. RESPONSE TO ERTA

The current charitable contribution tax deduction for grants of qualified equipment to universities which qualify under Section 170(e)(4) of the Internal Revenue Code (cost plus one-half of the "appreciation," limited to two times cost) is an appropriate and effective incentive.

Last August, we at Hewlett-Packard Company analyzed the amount of tax savings that would accrue to the Company because of the adoption of Section 170(e)(4) by the Economic Recovery Tax Act of 1981 (ERTA). We decided that the budgets for the upcoming fiscal year for charitable contributions would be increased by the amount of tax savings resulting from its new provisions. In other words, we chose not to plow the tax savings back into the Company's business, but rather to fund additional charitable grants.

In addition, because of Section 170(e)(4), during this year we approved a major program in excess of budgeted amounts that resulted in grants of computer networks to a number of universities.

Thus, during our current fiscal year, Section 170(e)(4) generated additional equipment grants of $1.2 million at cost, which has a value to recipients of approximately $3.5 million.

Clearly, allowing tax deductions of up to two times cost provided an incentive for Hewlett-Packard Company to increase its grants of equipment substantially, and we believe this formula provides an incentive for other companies as well. We do not believe that it is necessary to allow a tax deduction for the full market value of products. This approch has historically raised concerns that we hope will not be raised in conection with equipment grants of scientific equipment.

DESCRIPTION OF HEWLETT-PACKARD CO. EQUIPMENT GRANTS PROGRAM

It has long been recognized by the Hewlett-Packard Company that there is a great need for improved scientific and technical education in the United States, if the U.S. is to maintain a competitive edge in the world marketplace for sophisticated electronic equipment and computers. We have attempted to meet this need by increasing the value of charitable contributions made by Hewlett-Packard Company from $3.7 million in our fiscal year 1978 to $10.0 million in fiscal year 1981. We estimate that charitable contributions in our current fiscal year will be $15 million. Most of this increased giving has been of equipment.

The wide spectrum of philanthropic programs at Hewlett-Packard can be grouped into three main recipient categories—national, community, and academia.

One current example of a Hewlett-Packard national cash grant is our co-support, along with the National Science Foundation, of science reporting on the large network of National Public Radio stations. Expanded literacy in science, technology and medicine is widely recognized as a crucial need in America. Another example is a program that we have been conducting since 1975 of loaning talented employees to teach science and engineering courses at minority colleges and universities.

Our community grants programs involve contributions at local sites, as well as company-matching of the United Way contributions of employees. Widespread involvement by literally hundreds of employees in grants decision-making and implementation is a cherished source of employee citizenship satisfaction throughout the Company.

Hewlett-Packard product group teams initiate grants in the largest category of all—grants of advanced scientific, technological, and medical equipment to U.S. universities and colleges, and to a few selected high schools for personal computer products.

Hewlett-Packard Company has been making grants of equipment on a systematic basis since the mid-1960's. We believe that the special effort involved in making equipment grants is particularly worthwhile because for any given level of contributions expense at manufacturing cost we can provide equipment which has a substantially greater value to recipients.

To obtain the leverage that equipment grants can offer requires significant additional expenses in excess of the manufacturing cost of the equipment granted. Such expenses include warranty, shipping, field placement, and the administrative expenses of making grants. These administrative expenses are significant since they include the direct costs of those who coordinate our contributions program on a company-wide basis, as well as thousands of hours spent by our product groups to evaluate grant requests, which are made in far greater amounts than we can accommodate. It is extremely important for us to carefully evaluate grant requests to ensure that the recipients are capable of using and maintaining sophisticated technological equipment.

Because equipment granting presents special challenges and hurdles, Hewlett-Packard has heretofore been joined by only a handful of other technical companies in this specialized endeavor. Although an equipment gift can prove to be considerably more effective than an equivalent amount of cash for the recipient institutions, for the larger society in which it is embedded, and for the granting entity, this form of philanthropy has not been pursued extensively among corporate givers because of two main factors: 1. It is much simpler to pick up a pen and write out a check than it is to assess the technological and ongoing support requirements involved in such equipment grants; 2. The tax deductibility provisions have been less than inspirational.

The first challenge will probably always remain a part of this form of philanthropy when sophisticated technological apparatus is involved; the second challenge is being addressed here today.

RECOMMENDED CHANGES IN SECTION 170(e)(4)

Hewlett-Packard Company supports several changes in Section 170(e)(4) to provide further incentives for grants of scientific equipment to educational institutions by a broader range of corporations.

Elementary and secondary schools.—First, and perhaps most importantly, the eligible recipients should be expanded to include secondary and elementary schools. Institutions of higher education would be joined by these other educational institutions in receiving the benefit of incentive provisions. In this way, a much broader student population would share in a nationwide movement to expand computer and science literacy.

Use in all education, including community colleges.—Another change would be to increase the permissible uses of qualifying equipment to include equipment used in the direct education of students in the United States in all disciplines. This would allow a broader range of students and programs to use computers, which will add significantly to the general computer literacy of future generations of Americans and which will certainly enhance the overall productivity of the U.S. economy.

This change would also make it quite clear that equipment which will be used in community colleges for technical, as opposed to scientific, training will also qualify for the tax incentive.

Equipment should include computers for all applications.—We recommend that the definition of the equipment which qualifies under Section 170(e)(4) should be expanded to include technical equipment or apparatus in addition to scientific equipment or apparatus. This change will make it clear that items such as a computer or computer peripherals used in a nonscientific application would unquestionably qualify.

SUNSET PROVISION IS INAPPROPRIATE

Hewlett-Packard Company strongly believes that there should be no sunset provision in legislation which expands the incentives for giving scientific and technical equipment to educational institutions. There are a number of reasons for this belief.

First, computers and the equipment used in scientific and technical fields become more sophisticated at an ever increasing rate. The need of our schools for new, sophisticated scientific equipment will continue for the foreseeable future, much beyond the duration of any sunset period.

Second, the need is probably much greater than can possibly be met in one or even several years, even assuming substantial increases in school budgets, as well as grants by equipment manufacturers.

Third, the educational process requires teachers, textbooks, and a curriculum, in addition to computers and scientific equipment. Allowing a program to develop over a number of years will allow better utilization of all resources devote to education. For example, it is not clear whether one computer in every school would produce a better, similar, or worse result for the nation than two computers in half the schools, or a computer lab in a quarter of the schools. A longer-term approach would allow computers to go first to the schools that are best prepared to use them for instructional purposes, and then to other schools as teachers and curriculum become better adapted to undertaking this kind of new challenge.

Fourth, the long experience of Hewlett-Packard Company at granting equipment has shown us that corporations that do not currently make substantial equipment grants may require several years to learn to make such grants effectively.

CONCLUSION

In summary, Hewlett-Packard Company is delighted that this Subcommittee is considering new ways to broaden categories of eligible recipients of equipment under Section 170(e)(4).

We believe that the Congress can do this effectively by the following amendments to Section 170(e)(4) of the Internal Revenue Code:

1. Delete references to institutions of higher education in subparagraph (B)(i); and
2. Modify subparagraph (B)(v), which defines qualified equipment, to read as follows: "the property is scientific *or technical* equipment or apparatus, substantially all of the use of which by the donee is for research or experimentation (within the meaning of Section 174) or for research training in the United States in physical or biological sciences, *or is directly for the education of students in the United States.*" [Proposed additions in italic.]

Chairman **Stark**. Thank you very much for excellent testimony. Mr. Vander Jagt?

Mr. **Vander Jagt**. I have no questions, Mr. Chairman, but I would like to thank our panelists for their very excellent and thought-provoking statements.

Chairman **Stark**. I have a question for Mr. Rogers, but I am asking your opinion, not that of your employer.

In your opinion, as an observer of the home or personal computer industry, do you feel that the offer will be met by one, two, or three manufacturers of competing equipment?

Mr. **Rogers**. Let me see if I understand it——

Chairman **Stark**. I know you can't speak whether Hewlett-Packard would donate computers or not. There is Atari and Radio Shack and Osborne in my district. Do you suspect there would be other manufacturers who would step up to the window and match the offer that Apple has made to the educational institutions of this country?

Mr. **Rogers**. To match it in magnitude would be rather difficult, in my view. I think that is an enormously generous offer of Apple. I have got to put my company hat back on because we have learned that since the Economic Recovery Tax Act passed last August, that a number of companies are coming to us now to learn how to give equipment.

It takes time to learn how, and chances are that other companies who are in the same business as Apple will want to learn how to do this. I don't think they can give at that magnitude, but they certainly will want to help, in my view. They are as aware of the national problem as all of us are.

Chairman STARK. Also, in Mr. Jobs' testimony, he was talking of the unrecovered costs after taxes which were to be at least $100 a computer, including such cost of handling, shipping, installing, and just the administrative costs to running a purchasing program.

Mr. ROGERS. Independent of philanthropy, you mean?

Chairman STARK. Well, I got the feeling that the Treasury testified in particular that the existing manufacturers are getting all of their money back. I just wondered if you would concur with me that there is a real cost in the administrative side.

Mr. ROGERS. I concur with you totally. I would add beyond that that it is harder to give something away wisely than it is to sell it. Therefore, we take an enormous amount of care in that. We have a vast network that helps us decide these things.

It all costs money, which is not charged to philanthropy, by the way. I agree with that totally.

Chairman STARK. Thank you.

Steve, I wanted to thank you again. As you know, you are terribly modest about being the incentive for this legislation.

You are to be commended, and we can all speculate as to the future of the legislation.

I wanted to thank both of you.

Thank you very much for appearing today.

Our next panel is composed of Dr. Karen Sheingold, director of the Center for Children and Technology, Bank Street College of Education, New York; Prof. Karl Zinn, Center on Learning and Teaching, University of Michigan; Ms. Ann Lewin, executive director of the Capital Children's Museum; and Don White, deputy superintendent for congressional relations for the California State Department of Education.

Would you like to array yourselves at the witness table? If the witnesses would bear with me, I am going to run the lights, which indicates when 5 minutes of summarizing your written testimony is up, with the exception that if you oppose the bill, you can have more than 5 minutes—what could be fairer—then have all of the time you want.

But the lights will be necessary, in consideration for the witnesses we have and with my apologies, because I find this fascinating and could go on all afternoon, but then we won't finish. So I have to use the lights as an indication of about 5 minutes apiece. Then we have some questions.

I ask you to proceed in the order listed on the witness sheet. Dr. Sheingold, would you like to proceed?

STATEMENT OF KAREN SHEINGOLD, PH. D., DIRECTOR, CENTER FOR CHILDREN & TECHNOLOGY, BANK STREET COLLEGE OF EDUCATION, NEW YORK, N.Y.

Ms. SHEINGOLD. Yes, and I will try to take less than 5 minutes because some of what I wanted to say has already been eloquently said by other witnesses.

I am delighted to be here and to speak in support of the Technology Education Act of 1982. I do so for three main reasons, because I think that there are three very important issues the passage of this bill will begin to address.

The first is that of computer literacy, which many people have discussed and I will not make any additional comments on, but I think it is a critical, critical part of what students in elementary and secondary schools must learn, and they must learn it now.

Second—and this is a related issue, it happens to be one that I am very concerned about—there are growing inequities in the access to microcomputers in schools today. While all schools are finding it increasingly difficult to buy computer hardware, more affluent school systems are still managing to buy microcomputers. Computer manufacturers are being told that they should market their equipment to those school systems.

In those systems parents have often played a very critical role in helping to raise money for the purpose of the computer hardware. In less affluent schools and school systems there are neither the tax revenues nor the wealthy parents who can make contributions.

If permitted to continue, these inequities will systematically handicap students from poorer schools and school systems. Ironically, these students who miss out are also the very students who won't have computers at home, who will not be sent to computer camps, the ones who won't have other opportunities to experience this new technology. I think this is a critical problem and one which the passage of this bill could begin to address.

Third is the inadequate supply of mathematicians, scientists, and engineers in this country. The teaching of mathematics and science, as you know, at the elementary and secondary levels is suffering from a lack of qualified teachers.

Our current international lead in high technology fields may be precarious. It is possible that early involvement in challenging computer-related activities, such as programing, will help to interest students in and prepare them for these careers, which will support our continued excellence in technology.

At Bank Street Center for Children and Technology, we are studying the implication of this technology for learning and literacy. I would like to point out we believe the microcomputer holds educational promise as a tool which can be used in fields as diverse as writing, music, graphic arts, as well as science and mathematics.

Its potential impact on the life of the classroom varies from enhancing children's intellectual abilities to affecting the way in which children work on tasks together and communicate about the work that they are doing.

We are well aware that computer hardware alone does not produce learning or literacy. How the computer is used, the extent and type of teacher training and the availability of quality software are among the many factors which in the end will influence outcomes.

Obviously, access to the hardware is a critical prerequisite for any of the outcomes we find beneficial and interesting.

Computers are very powerful tools. They are also expensive ones. Schools are eager to invest in the technological literacy of their students but can't afford to do so.

This bill will provide some of the help which schools need at a cost to the taxpayers which is a fraction of the amount that schools themselves would have to pay. Schools will then have to commit their own resources to seeing that this powerful tool is used in ways which are most beneficial to their students.

Having the necessary hardware will be a strong impetus to beginning that investment.

[The prepared statement follows:]

STATEMENT OF KAREN SHEINGOLD, PH. D., DIRECTOR, CENTER FOR CHILDREN & TECHNOLOGY, BANK STREET COLLEGE OF EDUCATION

I support the Technology Education Act of 1982. With its passage Apple (and perhaps other manufacturers) will donate microcomputers to every elementary and secondary school in the country. This availability of hardware can have three important effects. First, it may increase computer literacy. Second, it may help to counter growing inequities in access to computers. Third, it may enhance the development of future mathematicians, scientists and engineers. On the first point, computer literacy is becoming essential to the education of students in elementary and secondary schools. Students are growing up in a society in which they must both know about computers and know how to operate and program them. Such knowledge and skill is not optional. Many jobs now require some knowledge of technology. Five years from now computer illiteracy may be equivalent to not knowing how to read, in a large segment of the job market. In order for students to contribute significantly to the work force and to function in our technological society, they must understand the technology.

Second, there are growing inequities in the access to microcomputers in schools. While all schools are finding it increasingly difficult to fund hardware purchases, more affluent school systems are still managing to buy microcomputers. In these systems parents often play a leading role in contributing funds towards the purchase of microcomputers hardware. Less affluent school systems have neither the tax revenues nor the parent contributions for hardware.

A recent study (conducted by Market Data Retrieval Systems) indicated that local budgets, and not state or Federal funds, are the principal determinant of the number of microcomputers purchased by schools. Thus it is not surprising to find an inverse relationship between student poverty and the number of microcomputers in schools. Of those schools where less than 5 percent of students were at the poverty level (i.e., eligible for Title I support) fully 30 percent had microcomputers. In contrast, in those schools where 25 percent or more of the students were at the poverty level, less than 12 percent had microcomputers.

If permitted to continue, these inequities will systematically handicap students from poorer schools or school systems. These students—the same students who will not have computers at home and who will not be sent to computer camps—will be excluded from acquiring a skill which will be critical to their survival in the work force.

Third, there is an inadequate supply of mathematicians, scientists and engineers in this country. The teaching of math and science at the elementary and secondary levels is suffering from the lack of qualified teachers. Our current international lead in high technology fields may be a precarious one. It is possible that early involvement in challenging computer-related activities, such as programming, will help to interest students in and prepare them for those careers which will support our continued excellence in technology.

At Bank Street's Center for Children and Technology, we are studying the implications of microcomputer technology for learning, as well as for literacy. We believe that the microcomputer holds educational promise as a tool which can be used in areas as diverse as writing, music, graphic arts, science and mathematics. Its potential impact on the life of the classroom varies from enhancing children's intellectual abilities to affecting the way in which children work on tasks together and communicate about that work.

We are well aware, however, that computer hardware alone does not produce learning or literacy. How the computer is used, the extent and type of teacher training, and the availability of quality software are among the many factors which influence outcomes. Yet access to the hardware is a critical prerequisite for any of the outcomes we envision.

Computers are powerful tools. They are also expensive ones. Schools are eager to invest in the technological literacy of their students but cannot afford to do so. This bill will provide some of the help which schools need at a cost to taxpayers which is a fraction of the amount schools would have to pay. Schools will then have to commit their own resources to seeing that this powerful tool is used in ways which are most beneficial to their students. Having the necessary hardware will be a strong impetus to beginning that investment.

Chairman **Stark**. Professor Zinn?

STATEMENT OF KARL ZINN, RESEARCH SCIENTIST, THE CENTER FOR RESEARCH ON LEARNING & TEACHING, UNIVERSITY OF MICHIGAN, ANN ARBOR, MICH.

Mr. **Zinn**. I have a written statement, which I won't read.

Chairman **Stark**. Your entire statement, Professor, will be in the record.

Mr. **Zinn**. Let me begin with three assertions——

Chairman **Stark**. These microphones work best if you swallow them. So pull that as close as you can. It will help our reporter and the rest of the people in the room if you do that.

Mr. **Zinn**. Three assertions about computers, schools, and technology education they almost go without saying. If people do disagree on these points, we ought to discuss them.

First, technology education is important to the United States economically and socially right now. We have heard that a number of times already this afternoon.

Second, technology education has to start early, before one gets a job, before one enters college or technical school, and probably before one enters high school. Mr. Chairman, you made appropriate remarks about that earlier, particularly when you were pressing Mr. Chapston on helping elementary and secondary schools as well as colleges and universities.

Third, small computers are effective tools for technology education in homes and schools today. They are more than just good tools, they open up new ways of thinking.

Just as erector sets, bicycles, cars, and radios have been tinkertoys of our Yankee ingenuity, computers are the thinker-toys of the current generation. What we are talking about today is not just an investment in technology, but an investment in the important human resource.

Let me get to the heart of my experience and expertise. During the last 10 years I have examined support networks for computer use in schools and community centers. We've found a variety of ways to support technical innovation in the schools, as well as colleges and universities.

I won't elaborate those points, but they led me, as soon as I heard about this bill, to call a number of people who work with computers in schools. I also called representatives of publishers, manufacturers, professional associations and other organizations that are concerned with computers and education.

In my written statement I summarize some benefits and concerns from the perspective of those people who would be affected by the proposed legislation. Confirmation of many of the points has already appeared in other testimony. I would add only that I found overwhelming support for H.R. 5573 because it is such a simple step and so sure of bringing benefits to a large number of schools.

We have computers in perhaps 10 percent of our elementary schools now, 25 percent of the junior high schools, and still no more than 45 percent of the high schools. Usually this is just one work station for many, many students, with little material assistance.

But what I see happening, were this bill enacted, is the schools getting excellent help from the professional associations, clearinghouses, the State and regional service centers, science centers, universities, and colleges. We sometimes overlook important contributions from public libraries, computer clubs, computer stores, and local businesses.

It is this network of supporting resources that I have been studying, and I am confident that it is going to assure that the program of donations will be done effectively, that is, appropriate donations will be rewarded and inappropriate ones will be discouraged.

Details of this support, including some suggestions for clarification or emphasis in the bill, are in my statement.

Let me sum up the benefits and add a simple measure of immediate results .

One: within a year, 1 million graduating seniors who wouldn't otherwise have had access to a computer, will be better prepared for work, for technical training and for further education. I am making a very modest estimate of 40 graduating seniors for each of 25,000 computers that wouldn't have been there without your action.

Two: the benefits will expand dramatically for a long time to come as increasing numbers of people acquire skills and all of us find increased opportunities to become comfortable with the technology, to gain a sense of mastery over the computer, to use it well rather than be used by it.

Three: revenue lost for 1 year is a small cost to prime the pump. It will be returned many times over in tax revenues on new markets for education in the home as well as in the schools.

Four: if what is happening to our leadership in high technology were combined in one object and then flown over our country again and again, we'd cry Sputnik and do something about science and education and technical training.

You have before you a simple act that will help keep our country among the leaders in information systems and telecommunications. I urge Congress to take this small, sure step at a time when leadership is so needed.

Thank you.

[The prepared statement follows:]

STATEMENT OF KARL L. ZINN, RESEARCH SCIENTIST, UNIVERSITY OF MICHIGAN

The Congress of the United States can, in a small and simple step, advance this country a considerable distance toward significant and beneficial computer literacy. Although the Technology Education Act of 1982 is no "cure-all," passing it this summer would provide good results within one year and considerable long-term benefit. This tax measure simply extends to elementary and secondary schools the benefits of tax incentives already allowed for donations to universities. Getting computers into all of our schools strongly supports other steps which are being taken to help the American people achieve adequate literacy regarding new technologies.

ASSERTIONS ABOUT TECHNOLOGY EDUCATION AND COMPUTERS IN SCHOOLS

In order to get right to the heart of my experience and expertise related to placing new equipment in schools, I'd like to begin with three assertions about computers and schools and technology education.

(1) Technology education is especially important to the U.S. economically and socially right now. Leaders from industry, government, education, economics, and many other fields have argued for greater investment in education and training which would: a) develop a technically literate workforce; b) encourage more young people to enter scientific and technical fields; and c) provide the basic skills and understanding that every citizen needs to make good decisions in a technological world. Every day I see new examples of how technical knowledge and skills determine who gets jobs, which businesses survive, and how technology is used or misued in the workplace, in commerce, and in entertainment. Our present system for science and technical education needs help!

(2) Technology education has to start early, before one gets a job, before one enters college or technical school, and probably before one enters high school. Experts in engineering and technical education tell us that positive experiences with science and technology in junior high and elementary school make a significant difference in career choices, in how people use technology, and in lifelong attitudes toward science. I've seen the beneficial effect of these early experiences many times in the families and schools of my community. Often the starting point was access to a single computer in the classroom or library (or the home!) some time between 6th and 9th grade.

(3) Today's small computers are effective tools for technology education in homes and schools. Because they are inexpensive, portable and convenient, person-sized computers make a significant difference in kids' perceptions of technical equipment. Children quickly become comfortable with computers and want to understand the technical world. They begin to explore the roles computers might play in their lives and in society.

The fact that personal computers are widely used in the best engineering schools confirms that they are serious tools, not just toys. Indeed, they are more than just good tools; they open up new ways of thinking about information and procedures, systems and objects, decisions and values. Just as erector sets, bikes, cars and radios have been the "tinkertoys" of our Yankee ingenuity, computers are the "thinkertoys" of the current generation. This country badly needs the skills and creativity which result from the challege of working with computers from an early age.

(I will not take time to describe the situation schools face: very little money to spend on technology; donations from industry are down due to the economy; schools are under considerable pressure from parents and community leaders to provide students experience with computers; only 10 percent of the elementary schools have even one computer for kids to use; less than half of our high schools, mostly the large one in affluent areas accustomed to spending more on learning materials, report providing student access to computing; etc.)

WHY A UNIVERSITY RESEARCHER WITH MANY COMPUTERS WOULD COME TO TESTIFY

My interest in this bill stems from the many occasions I've seen one computer make a difference: students learn, they grow, and they come to contribute more to society—and the economy. Greater computer literacy will benefit our economy (through more skilled workers, less unemployment, better R&D, etc.), but anyone who appreciates what knowledge of computers does for individuals will be impressed by the positive effects and want to help get computers into schools.

Many computer manufacturers have donated machines to the University of Michigan for basic research under present tax law that allows generous deductions of the donor. My research on learning in lab situtations has been helped, but I also care very much about how computers are used for learning and teaching in homes and schools now. On numerous occasions I have shifted some effort from research and development activities (my primary function at the Center for Research on Learning and Teaching) to service projects which provide more immediate advantage to teachers, students and parents. Indeed, I redirected some of my research program to examine support networks for computer use in schools and community centers. Since 1971 a series of projects (supported in part by Exxon Education Foundation and the National Science Foundation) has developed and confirmed the effectiveness of a variety of ways to support technical innovation in the schools as well as colleges and universities. However, most of the schools need financial help getting started.

I'm convinced by numerous studies and demonstrations that teachers and schools getting their first computers can help themselves through information, examples, advice, and the support networks already in place. I've helped develop resource networks so that information and advice gets to the people who need it at the right time. I've studied those networks to be sure they are delivering the service as it is needed. And occasional direct involvement in providing that service has been personally rewarding while at the same time confirming the results of the surveys and experiments.

Just three weeks before I'd been in Washington to assist with a short course in computers for Congressmen. I was impressed again by how quickly and easily adults who are interested in exploring the technology will pick up the skills and see the relevance of computer use in education and decision making.

BENEFITS AND CONCERNS RELATED TO THE PROPOSED LEGISLATION

As soon as I heard of this bill I called a number of experts and assembled a list of benefits and concerns: impact of the proposed legislation on students and teachers, the costs and benefits for manufacturers, the impact on the publishing of computer-related materials, and the logistics of implementation. A packet of information was distributed to more than 200 people in the network of developers and support staff for computers in schools. Conversations with about 50 of these people to explore their opinions and advice provided a sound basis for my testimony today.

The resource people in the schools told me that if the Technology Education Act does get computers into the majority of schools that don't have them now, it will help interested teachers who have had no equipment to get something started, and it will provide an opportunity for many more teachers to become familiar with computers. A more important long-run result for the students who will eventually use computers is that getting equipment into the schools now provides teachers and administrators appropriate experience on which to base decisions about equipment selection, software (e.g., programming languages), applications, and curriculum. These local resource people warn us not to expect too much from just one machine in a school. They advise their schools to begin modestly with an elective class, with a computer club, and with self-education for teachers. Make sure that the teachers and students who are most interested in computers have easy access to whatever machines are available. Look to computer education and teaching magazines for training and support materials, and for advice on the contributions computers can make to learning and teaching.

I also contacted representatives of publishers, manufacturers, professional associations and other organizations concerned with computers in education. All of them had heard of the bill and were making plans for appropriate responses to it. Each manufacturer will respond in ways consistent with its approach to the education market, and offer what can be done well and supported at each site with documentation, training and service.

The publishers tell me they have good literacy materials and will get the best books and programming languages to the schools. Getting computers into tens of thousands of additional schools will prompt them to produce more educational software. Having more applications available will result in more people buying computers. More computers further expands the market for the publishers, and so on!

A number of teachers in Michigan told me what they would do with a "free" computer. Those that already have machines described what would be done with a small number of additional machines in their schools. Those with schools had no computers spelled out what it would take to get started with the first machine. They all like the fact that donations would help many more students get started now on computer literacy and skills essential to many careers. Just having ready access to a computer encourages all students to consider technical and scientific areas of study and employment. One teacher pointed out how having a computer that is used effectively educational activities at school (with these activities made apparent at open-houses and the like) has helped families select a computer and better use it for home education. The major concern was to have enough time to plan for computer use, and to have full support from the administration and good technical help where it may be needed.

A PERSONAL STATEMENT IN SUPPORT OF THE TECHNOLOGY EDUCATION ACT

A new "Sputnik" is crossing over our country but hasn't yet made any dramatic appearances. Japan and other nations are in the process of taking over leadership in computers and information systems, the last area in which the U.S. has excelled in technology. Yet we still have the creative minds, the flexibility, and the kind of educational system needed to retain leadership, if only we don't starve the curious and inventive minds of our current generation.

I wholeheartedly support this legislation because it is a simple step forward, and an action which is sure to benefit many schools. The donors will do the best they can for the schools, since success in future sales depends on the successful use in schools of the equipment donated. Publishers will invest more in development and training since the market holds promise of copies sold to many more schools and individuals.

The Techology Education Act will do some "pump priming" in our educational and economic systems. The tax incentive will help put many more machines in schools at a fraction the cost of usual funding mechanisms. The additional expense of demonstrations, training, technical support, and diffusion of new ideas will be distributed throughout the system which supports educational use of computers. In addition to the manufacturers, schools will get help from publishers, professional associations, clearinghouses, state and regional service centers, science centers, universities and colleges, public libraries, computer clubs, local stores, and so on. More machines in schools, and more attention to the needs and benefits, will result in larger investments by the private sector in materials needed by the schools.

In supporting this legislation, I do not mean to represent the Technology Education Act as the only measure that needs to be taken in this and related areas. Many other things merit Congressional action, and some may require appropriations. Long-term success depends on development centers, teacher training programs, more and better computer-related training materials, innovative technical developments, research on technologically-based learning, and research on the impact of computers on individuals, families, and society.

Many factors will affect the use of computers in schools. But whatever else occurs, extending this tax incentive now to place computers in schools as well as universities will enhance the results. Teachers and administrators will have better experience on which to base decisions about equipment, programming languages, applications and curriculum. Efforts to disseminate new ideas and materials will build upon a base of experienced people in the schools. And the equipment in place will make it possible for teachers to test out new materials locally.

SOME POINTS TO CLARIFY AND EMPHASIZE WITHIN THIS BILL

Equipment will be needed for teacher training programs at universities, colleges, and the regional centers serving groups of school districts.

Equipment will be used well by students of all ages at other public education sites such as science centers, community centers, and libraries which may not be part of an elementary or secondary school.

Essential instructional materials and sample applications should be part of the package for which the donor gets credit.

The federal agencies concerned with science and technology education should assign appropriate resources to assist schools and teachers in ways that increase the effective use of the donated equipment.

The schools should provide a short planning statement telling who will be responsible for the equipment and how it is to be used. This might be part of the written statement on use and disposition of property donated (presently "used in education of students . . . not transferred in exchange for money, other property or services"). Of course these statements would be public information and helpful for professional associations who want to offer help to schools which may need it, as well as a basis for checking on the equitable distribution of machines.

SUMMARY

The proposed legislation is straightforward in that it simply extends to schools the benefits of a tax credit already allowed for donations to universities. This action to encourage distribution directly to schools bypasses the complexities and costs of proposal preparation, review, approval, and administration; and it gets teachers and schools started right away on a self-help program to bring them into the computer age.

The computer education market and the support network for computers in schools will reward appropriate donations and discourage those that will not be productive. Each donor will put forward the best package possible to support technology education so that the recipients will come back to purchase present and future products. No donor wants its equipment to be criticized as obsolete and unreliable, or inconvenient and irrelevant for technology education. Publishers will put out the best text materials and computer programs they can afford to produce (and schools will buy) in order to capture their share of the new market for computer education materials. Others who have a stake in computer use in schools will do their best to see that recipients make good choices in selecting machines and learning materials, find appropriate help with teacher training and support, and put the equipment and materials to good use.

(1) The benefits of having computers in nearly all schools will show in the skills and interests of students in the computer clubs and classrooms that get machines in the first year this legislation takes effect.

(2) The benefits will expand dramatically for a long time to come as the market forces take over to provide an increasing amount of quality, computer-related instruction materials. More people will acquire technical skills that are important on the job, and all of us will find increased opportunities to become comfortable with the technology so pervasive in our society.

(3) Attracting national attention to information systems and technology will help keep our country among the leaders in this field which now dominates national economies and international trade.

(4) The small cost (in lost revenues for one year) to "prime the pump" will be returned many times over in tax revenues on new markets for education in the home as well as in schools.

Please take this small, sure step at a time when leadership is so needed.

Chairman **Stark**. Ms. Lewin?

STATEMENT OF ANN W. LEWIN, EXECUTIVE DIRECTOR, CAPITAL CHILDREN'S MUSEUM

Ms. **Lewin**. Thank you, Mr. Chairman.

I am delighted to be able to talk with you today. You have already heard testimony on the savings that will accrue from enacting this bill. The question is not, can we afford to pass it, but can we afford not to pass it?

What is at stake is not the issue of whether one or two companies will get a good deal financially or publicity for their names. What is at stake is the mind set of America and the intellectual capacity of our children.

Twenty-five years ago Sputnik went up and the Nation panicked because we were behind the Russians. It became a matter of the highest national priority to put a man on the moon, to demonstrate we had not lost the position of world leadership.

I won't reiterate the facts about how far our children are behind the Russians and the Japanese and other countries in the world. I will read two things:

First, Lester Thurow in Newsweek in March said:

> Math and science education is dissolving as math and science teachers abandon our school systems in droves for better paying industrial jobs. Many high schools now have no qualified math teachers on their staffs. Last year in New York City one out of every two people who took the examination to see whether they were fit to be telephone operators flunked.

Second, today, in the D.C. public schools arithmetic computation skills are up 6 months, but application scores are down by 6 months. Good computation depends upon memorizing; good application depends on good thinking. There is evidence that Johnny might be able to add, but may not be able to think.

The evidence indicates that the educational system is floundering and its graduates are unfit educationally to handle even routine tasks.

What does the computer have to do with all of this? The computer provides a new way of thinking. This fact is becoming so widely recognized it even appears in in-flight airline magazines.

"United, the Magazine of the Friendly Skies" had an article by Joel Makower that said, speaking about an electronic budget tool:

> The result of using VisiCalc is not just speed or accuracy but insight. You find that one whole class of variables you thought was important doesn't make a shred of difference, and you find that an apparently insigificant variable is thrashing the whole model around.
>
> You go back through and find that variable A is multiplied by variable B, and suddenly there is the multiplier effect. Eventually the numbers recede in importance, and you get a visceral understanding of the fabric and play of this model; that is, you begin to understand how your business really works.

What is at issue? Getting computers into the schools is helping our kids learn a whole new way of thinking. Great Britain, Germany, France, Japan, and other world powers will have a computer in every school before the end of 1982 with a teacher trained to use them. We cannot afford not to get computers into American schools.

I will return for a minute to the point about a new way of thinking.

We are living in a period when change is rampant and technologies are revolutionary, but traditional institutions are moribund. Congress can't get its budget passed, Detroit can't turn out cars with competitive performance for a price, the schools can't turn around test scores which have been falling for two decades.

Our institutions defy management and no longer perform the functions for which they were created. Since the 1890's education has been the root of our Nation's success. Education for the 1990's may well be the root of our survival.

We cannot afford not to pass the Education Technology Act of 1982. We cannot afford to deny our children access to the tool which opens new patterns of analysis and new thinking skills.

Can you imagine not being able to read? Have you ever been in a country where even the shapes of the letters are different, where nothing is familiar, where you feel a moment of panicked dependence on others because you can't read?

Our generation needed to be letter-literate. Today's childen need to be computer-literate. Education in using computers, computer literacy, will be a critical survival skill. I would urge us to get on with the business of passing this bill.

Thank you.

Chairman STARK. Thank you very much.

[The prepared statement follows:]

STATEMENT OF ANN W. LEWIN, EXECUTIVE DIRECTOR, CAPITAL CHILDREN'S MUSEUM

I am Executive Director of the Capital Children's Museum. We have a large computer education center at the Museum and last month we presented a course in Computer Literacy for Members of Congress. Under the sponsorship of the Congressional Clearinghouse on the Future, we taught 38 Members how to use a computer.

I have been asked to testify on the Technology Education Act of 1982. H.R. 5573 proposes to amend the tax law so that a computer can be donated to every school in the nation. You have already heard testimony on the savings that will accrue from enacting this bill. The question is not can we afford to pass this bill. It is: can we afford not to pass this bill?

What is at stake is not the issue of whether one or two companies will get a "good deal" financially, or publicity for their names. What is at stake is the mindset of America and the intellectual capacity of our children.

Twenty-five years ago, Sputnik went up, and the nation panicked—we were behind the Russians. It became a matter of the highest national priority to put a man on the moon to demonstrate that we had not lost a position of world leadership.

Today, we are again behind the Russians, and the Japanese, and other countries in the world. Note these facts:

1. 1967: study by Torsten Husen entitled "International Study of Achievement in Math": "In the four age groups, the United States placed at the bottom of the ten countries twice, and second and third from the bottom once. Japan placed first, second, third, and sixth from the top."

2. 1973: study by Comber and Keeves entitled "Science and Education in Nineteen Countries": "In an international study of achievement in science among 14 year olds, Japan ranked 1st, the United States ranked 15th. Japanese 11 year olds outperformed American 14 year olds and Japanese 14 year olds outperformed American 17 year olds in an international test of science achievement."

3. 1980: study by NSF entitled "Science and Engineering Education for the 1980's and Beyond": "5 million Russian high school students take 2 years of calculus. 105,000 U.S. high school students take 1 year of calculus. Russian students also take 1-2 more years of algebra; 8 more years of geometry; 4 more years of physics; 3 more years of biology; 6-10 more years of workshop or hands-on lab."

And from the same study: "Japan graduates 20 percent of its college students with degrees in engineering; the U.S. graduates 6 percent. Japan graduates 65 percent of its students with degrees in science; the U.S. graduates 30 percent."

4. March 4, 1982, Lester Thurow, "Newsweek," page 67: "Math and science education is dissolving as math and science teachers abandon our school system in droves for better-paying industrial jobs. Many high schools now have no qualified math teachers on their staffs. Last year in New York City, one out of every two people who took the examination to see whether they were fit to be telephone operators flunked."

5. Today, D.C. Public School—arithmetic computation skills are up six months but application scores are down by half a year. Good computation depends on memorizing; good application depends on good thinking. There is evidence that Johnny may be able to add but may not be able to think.

The evidence indicates that the education systems is floundering and its graduates are unfit educationally to handle even routine tasks.

What does the computer have to do with all this? The computer provides a new way of thinking. This fact is now so widely recognized that it even appears in inflight airline magazines: June 1982: "United, the Magazine of the Friendly Skies." Joel Makower in an article entitled "Computers: The Executive Generation" writes on the effects of using a piece of software that is an electronic budget tool: "The result (of using VisiCalc) is not just speed or accuracy, but insight * * *. You find that one whole class of variables you thought was important doesn't make a shred of difference. And you find that an apparently insignificant variable is thrashing the whole model around. You go back and look through the model and find that variable A is multiplied by variable B, and suddenly there is the multiplier effect. Eventually the numbers begin to recede in importance, and you get a visceral understanding of the fabric and play of this model—you begin to understand how your business really works."

What is at issue in getting computers into the schools is helping our kids learn a whole new way of thinking! Great Britain, Germany, France, Japan, and other world powers will have a computer in every school before the end of 1982 with a teacher trained to use them. We cannot afford not to get computers into American schools.

I must return to the point about a new way of thinking. We are living in a period when changes are rampant and technologies are revolutionary; but, traditional institutions are moribund: Congress can't get its budgets passed; Detroit can't turn out cars with competitive performance or price; the schools can't turn around test scores which have been falling for two decades. Our institutions—government, industry, education—have become so complex they defy management and they no longer perform the functions for which they were created. Our individual jobs are also marked by increasing complexity. Consider, the front of an International Harvester tractor looks like the control board of a jet aircraft. Or consider: when you next step on an airplane the co-pilot may be on his very first flight; his entire training may have been done sitting on the ground using a computer simulator. Consider the social security fund is said to be running out of money, and economic experts cannot agree on how to redress the matter. Consider, Gordon Bell, Chief Scientist of the Digital Equipment Corporation, who has been a leader in calling together major computer companies to pool R. & D. efforts is afraid, in his own words that even if the companies can come to an agreement on how to pool their efforts to avoid R. & D. duplication, they may not have sufficient funds to beat Japanese competition.

Since the 1890's education has been the root of our nation's success. Education for the 1990's will be the root of our survival.

We cannot afford not to pass the educational technology act of 1982. We cannot afford to deny our children access to the tool which opens new patterns of analysis and new thinking skills. Can you imagine not being able to read? Have you ever been in a country where even the shapes of letters are unfamiliar? Did you feel a moment of panicked dependence on others because you were non-literate? Our generation needed to be letter-literate; today's children need to be computer literate. We shall cripple them unless we teach them computer literacy. The computer is not a new frill, another classroom aid or a technological gadget. It is a tool of tomorrow just as in 1450 after the development of printing, reading became the tool of a literate society.

Four months ago, I testified before the Congressional Clearinghouse on the Future and said: "If sociologists one or two hundred years from now search for the causes of the downfall of America as a world power, they will not find them. The blueprint for our downfall will be drawn not in action but in inaction, or in lines so tiny, history will not see them. In T. S. Eliot's image there will not be one bang but rather hundreds of tiny whimpers as we take apart basic research, as we silently watch our scientists lured to other countries, as we let schools flounder with the new technologies instead of providing the means to harness them.

"The world challenge to our leadership has been thrown down; the threat to our leadership is real. But, if we act now, we can meet the challenge and throw off the threat. We have [illegible] computer corporations in the world. We have the best trained scientists [illegible]neers. We have twenty-five years of perceptive criticism of education and [illegible] for responsive educational options. Most important we have a nation [illegible]ho are showing us that they have the know-how to tackle tomorro[illegible] In computer arcades, at home computers, in public centers, in the[illegible], and occasionally in schools, the kids are embracing the technology. All [illegible] is give them the tools."

H.R. 5573 is givi[illegible]n to ensure that our children get the tools. Our children are our gr[illegible]al resources, and their education in the tools of tomorrow is our maj[illegible] the future. Let's get the Bill passed to ensure that our future will b[illegible]ositive.

(A backg[illegible]nd statement is attached which provides further support.)

BACKGROUND TO TESTIMONY OF PASSAGE OF THE EDUCATIONAL TECHNOLOGY ACT OF 1982

Computers, it is agreed, will have more of an impact on society and our lives than the printing press, the light bulb, and the automobile. They are already everywhere—in homes, offices, in the supermarket, the bank, under the dashboards of cars, in smart machines, in games. A study at the Harvard Graduate School of Education which is currently being compiled shows computers in 7,500 or about half the nation's school systems, and it is predicted that within this year the number will increase to equal all the machines currently in schools.

There has never been a technology which has aroused such a mixture of fascination and fear. Yet, Judah Schwartz, Professor on Engineering, Science and Education at M.I.T., has said that in its educational applications the computer may be an "insurmoutable opportunty". We may fail to realize the potential of this machine in education. A few of the reasons for this lie in the nature of the technology, some lie in the present State of the society. But the main reason we may fail to realize the computer's potential lies in the fact that we have not made computer competency a matter of national priority. The question of computer education cannot be examined without looking at both the society and national priorities.

In the year 1979, $105 billion was spent on recreation, liquor and the racetrack, almost as much as was spent on public education. In a nation that prides itself on being called-centered, whee are the priorities? The question of computers in education must be examined in the context of priorities, a difficult question in a period when cuts in government funds force us to ask if education is a national priority.

We are in a period of tumultuous change. Changing values are evident in increasing use of alcohol by teenagers, continued use of drugs, widespread venereal disease, pregnancy in children, and greatly increased crime. Change is widespread in institutions where the home, family, religion, and community institutions show breakdowns in traditional patterns, and a plethora of new forms, many with cultist characteristics. Changes in work patterns is seen in manufacturing industries: Congressman Quayle in yesterday's Washington Post said that more than half a million displaced auto workers would never return to their old jobs. The workforce in the auto industry is ⅔'s the size it was just three years ago and requires $2.7 billion in trade adjustment assistance, only $10 million of which is spent on training for new jobs. Changes in technology are thrusting us into an information age and raising hosts of new issues: Who will have access to information? is a question that plagues both nations and individuals. Can experts stay abreast of developments in their own fields? What privacy should be guaranteed to the individual whose personal statistics are recorded in dozens of comprehensive data bases? The rapidity and volume of changes are rending the fabric of society and threatening its stability.

What is the school's role in such times? Schools have historically been agents for training in values and meeting economic needs. When the masses had to be literate to manage work in the industrial age, the schools trained them to read and write. When white collar skills were needed, the schools added typing and business courses to the curriculum. As industrial growth slackened, length of schooling increased in part to keep people out of a workforce overburdened with workers trained for jobs that no longer existed. As we enter the information age, the critical question is: What do we need from the schools? Currently, we are educating students for a world that is rapidly vanishing because change is occurring so fast. The lack of modernization in industry is reflected in a lack of innovation in the schools. Traditional education is moribund as is the national economy.

Social patterns indicate that we need schools as places to park the kids. Because of shifts in family patterns, most families have either two working parents or single parents. The schools babysit while mommies and/or daddies work, and one of the results is the rash of behavior problems. The content of the curriculum is outmoded, and the students know it.

Once, it was possible to define a course of study which would guarantee that students became "educated": for many decades we proscribed a set number of years of literature, history, mathematics, and philosophy. No longer. Too many new fields burgeon and information becomes outdated too quickly. Moreover, the elementary school curriculum is no longer relevant: sums are more efficiently tallied by a calculator than by hand, yet calculators are not allowed in most classrooms. Spelling, punctuation and grammar can be perfect with a good work processor, yet students still memorize long lists of words and rules. The written word is far more legible when typed than when hand copied. But, the first six years of formal schooling are dedicated to teaching our children skills which are performed far more efficiently with modern information machines. Precious years of intellectual growth are wasted in rote memorization, and the effects are seen in the test scores. For example, in the District of Columbia, arithmetic computation skills are up six months, but application scores are down by half a year. Good computation depends on memorizing; good application depends on good thinking. There is evidence that Johnny may be able to add but may not be able to think.

Moreover, as computers proliferate and kids have access to programmed instruction, many may on their own with little adult assistance master the entire elementary school curriculum in two years or one year or even less time. Then, what will we do between kindergarten and sixth grade?

We need a new national blueprint for education, one which is flexible enough to accommodate to a rapidly changing society and one which makes use of new interactive educational technologies. A dominant concern in the 1980's will be major transitions as the United States changes from a post-industrial to an information society and a concurrent struggle to retain a position of world leadership. Education and training in information technologies may well be the keys that determine the future strength of our country.

After Sputnik in 1956 in response to strong feelings that American superiority had been challenged, there were cries for great changes in education as a means to regain stature. But, only superficial changes were made few of which remain today. Despite penetrating analyses and piercing criticism, the blueprint for a new form of education never emerged.

Studies of the 1980 census show another upswing in the birth rate. In three to four years, schools will be pressured by increasing enrollment at the same time as they are grappling with adjustments to new technologies. Yet, today we are in a period of sever cutbacks in education; for the past decade we have dismantled school buildings, and recently our best teachers have left in response to RIF's to be retrained for more lucrative jobs, many in the computer industry.

Where will we be at the end of the 1980's when we must educate increased numbers of children with discarded buildings, out-dated curricula, and a teaching force depleted by large scale moves into other fields? Will we reclaim former schools which have become out-moded? Will we rebuild in the model of the 1950's and 1960's? Or, will we forge a twenty-first century form of education, one that incorporates technologies being developed today, and one that is responsive to a society in which information rather than goods is the dominant commodity?

The pressure of increased numbers of school-aged children coupled with the continuing challenges to our superiority will, by the end of this decade, again make education the target for national concern. But, we must prepare now for the education of the 1990's. As we come to grips with the information revolution, we are moving toward a confrontation with education as it now exists. Historically, this country has shifted in dramatically short time; when challenged, we can change and we can forge a national concensus. We have the will, the resources, and the knowhow to shephard a rebirth in education. All we need is the mind-set to do so.

On January 27 of this year, the Washington Post ran a short article headlined: France Plans Computer World Center. The French government plans to create a NASA Of the media age and has proposed $20,000 million annually for a World Center for Microcomputer Science and Human Resources. This act reflects their strong belief in the computer as an agent for social change and their urge to compete effectively for primacy in the worldwide shift to an age of telecommunication. Their Center will place heavy emphasis on computer education and the third world; Saudi Arabia has already requested to be the site for the first pilot project.

And where have the French gone for the expertise with which to carry off their wonderful plan? They have come to the United States of America. They have successfully engaged several of our smartest computer scientists to make their ideas a reality: Dr. Alan Kay, who for a decade was the wizard of Xerox Corporation's Palo Alto Research Center and who calls the computer the pencil and paper of the future; Dr. Seymour Papert of MIT whose vision on how to use the computer interactively contains a blueprint for truly significant educational use of this new medium. Dr. Nicholas Negroponte, master planner of MIT's Architecture Machine which merged computer and video disk and the future of office management through computer graphics will direct the Center. Raj Reddy, Director of the Robotics Center at Carnegie Mellon University, our leading robotics center, will play a prominent role.

We are being robbed of our brains, not because these scientists are in any way disloyal or unpatriotic. Quite the contrary. At breakfast two days ago, I begged Alan Kay not to overlook the disenfranchised of this country in favor of the Third World, and he expressed strong love and allegiance for America. I am sure the other scientists would also. They are not leaving for lack of allegiance; they are not leaving for lack of money. They are leaving because they have been offered a goal that will employ a powerful new technology in the service of humankind. The French government has had the wisdom to forge a powerful organization, to have it report straight to the President, to fund it at a level commensurate with its importance, and especially to make education in the new technologies a matter of the highest national priority.

The new national blueprint has many forms. It is in schools, homes, community centers, museums and science centers, amusement parks, computer arcades, libraries, and shopping centers. The nation is playing with a rash of new electronic toys. What is needed is a national effort to make the technology work to our ends. We need cogent sets of questions, funds to develop the answers, and models of successful ways to diffuse the new technology throughout society.

The institution which I run is one of a number of possible blueprints. We have established a showcase called Future Center, which is a futuristic classroom in full view of the public where we are experimenting with computer education. I invite you all to visit. But, we need help as do the thousands of others who are experimenting with computer education. The national blueprint will provide for that help.

Specifically, we need to learn how to train teachers, parents, and those who will spearhead the spread of computer competency. We need to devise curricula for persons who will have to use computers both regularly and occasionally. We need to develop software that makes use of the interactive capacity of the popular and lower priced programmable computers. And, most importantly, we need to conduct research concomitantly with each of the above tasks. No longer can research be conducted in labs with tiny numbers of children and large numbers of graduate students and professors. The drop in costs of electronic components has made the computer revolution a populist revolution, and the research needs to be done with a broad cross section of our population, especially those who are disenfranchised and may not have access to computers unless computers are put in their schools.

There are other musts: We must help educational decision makers become aware of the options in educational technology. We must help parents become aware of which software has real educational value. We must help teachers become savvy software consumers. We must integrate video and computer techonogies in such a way that the strength of each technology is maximized and each is enhanced by the other.

And there are some must nots: We must not standardize too early on any machine or software approach. We must not set statewide approved software before there has been adequate time to develop large amounts of software. We must not let the field of educational technology be dominated by any one approach before there has been adequate development of many approaches. Above all, we must not be afraid to trust ourselves and our kids with new forms of learning. The human is the most adaptable animal and has forged language and writing, the two most powerful symbolic tools in all the world. These might never have developed if there had been school committees and legislated curricula.

The play in the computer arcades is telling us something. The youth dropping quarters in the machines and racking up enormously high scores are intuitively learning the algorythms programmed into the games. Youngsters in the human race have always learned vital techniques for survival by playing in harmless environments with models of real-world tools. The algorythms of the computer games may be models for tools of the next century. The blueprint for the new education must above all accommodate new forms of learning.

The United States has always risen to meet challenges successfully once there is public awareness that a challenge exists. The popular media is building public awareness of the challenge and the potential. I hope that the members of this Committee will use their power to meet the challenge in time to preserve our society. Our children are our gratest national resource, and their education in the tools of tomorrow's technologies is our major hope for the future.

Chairman **Stark**. Mr. White?

STATEMENT OF DON WHITE, DEPUTY SUPERINTENDENT FOR CONGRESSIONAL RELATIONS, CALIFORNIA STATE DEPARTMENT OF EDUCATION

Mr. **White**. My name is Don White, superintendent for congressional relations with the California Department of Education.

My purpose is to submit for your record two letters. First, a letter from Edmund G. Brown, Jr. Second is a letter to me from Ann Leavenworth, president of the State Board of Education, dated June 14, which says:

> At its Thursday, June 10 meeting the California State Board of Education voted unanimously to state its support on the Technology Act of 1982, as introduced by Congressman Pete Stark, H.R. 5573 and S. 281. The Board further expressed its desire that you represent the Board in making its position known at scheduled hearings when this proposal will be considered. We will follow with letters to the House Ways and Means Committee and the California Congressional Delegation.

Mr. Chairman, I submit those letters for your record.

[The letters follow:]

State of California,
Governor's Office,
Sacramento, May 26, 1982.

Hon. Dan Rostenkowski,
Chairman, Ways & Means Committee, Rayburn House Office Building, Washington, D.C.

Dear Congressman Rostenkowski: I strongly urge your support of HR 5573, sponsored by Representative Stark, which encourages contributions of computers and other sophisticated technological equipment to elementary schools and high schools. The use of computers to teach children represents a milestone in education and the development of young minds. Extensive experience already indicates that microcomputers can motivate students and develop creativity and new intellectual horizons in a way that has not been possible before.

To ensure that children all over America have an opportunity to participate in this exciting educational revolution, I believe computer manufacturers should be given a special incentive to donate computers to schools. HR 5573, by allowing the same tax deduction for donations to public schools that manufacturers now enjoy for university donations, helps accomplish this goal.

As the enclosed materials indicate, California is making a major commitment to training teachers and assisting them in software evaluation and programming. Passage of HR 5573 at the national level will go a long way toward helping us achieve our goals.

Thanking you very much for your consideration,

Sincerely,

EDMUND G. BROWN, Jr., *Governor.*

CALIFORNIA STATE BOARD OF EDUCATION,
Sacramento, Calif., June 14, 1982.

DONALD K. WHITE,
Deputy Superintendent for Congressional Relations,
Washington, D.C.

DEAR DON: At its Thursday, June 10 meeting, the California State Board of Education voted unanimously to state its support of the Technology Act of 1982 as introduced by Congressman Pete Stark and Senator John Danforth (H.R. 5573, S. 2281). The board further expressed its desire that you represent the board in making this position known at scheduled hearings where this proposal will be considered. We will follow with letters to the House Ways and Means Committee and the California Congressional Delegation.

We appreciate your assistance as always.

Sincerely,

ANN LEAVENWORTH, *President.*

Chairman STARK. Thank you very much. We have the Governor's support and the support of our fellow Californians.

Mr. Matsui?

Mr. MATSUI. I have no questions. I would like to thank the panel.

Chairman STARK. I have just one question, and I hope it will just elicit a yes or no answer.

One of the things that I remember is criticism from my alma mater, engineering school and other scientific schools, who say we have spent too much time training engineers and scientists to make scientific empirical decisions, and not enough time spent into this sort of process; in other words, we were trained to know what we could do, but we were never trained to think about what we ought to do.

Do you have any fear that flooding the schools with computers will give us a generation not just of technically literate people, but of little pac people who would push buttons without thinking? Are you all feeling that we may not be opening the bottle and letting the genie out?

Ms. LEWIN. I don't think we need fear that. The computer doesn't respond that way. You have to think about what you are doing when you push that button and, hopefully, having to think will transfer a skill that the kids will learn to use in whatever they do.

Chairman STARK. Professor?

Mr. ZINN. I would add the idea that putting a small, easy to use computer in the hands of children will show them from an early age that it can be mastered, and put to the human purpose. This will protect against the situation where we become slaves to technology and let it run our lives and twist our values.

Chairman STARK. Ms. Sheingold?

Ms. SHEINGOLD. As you know, there are many "ought" issues connected with the computer itself and how to use the information from computers. I think having computers in schools can provide interesting opportunities for kids to entertain those kinds of questions. I think in that sense they are good.

Chairman STARK. I think they could almost program a lot of things like that, but I didn't mean to cut your answer.

Mr. WHITE. I agree with the responses stated by my colleagues here.

Chairman STARK. I thank you all very much for preparing your testimony for the hearing today. I appreciate it.

Our next panel will consist of Dr. Franklin Zweig, American Association of Colleges for Teacher Education; Mr. Richard Kruse, director of government relations for the National Association of Secondary School Principals; and Rayma C. Page, president, National School Boards Association.

Mr. Zweig.

STATEMENT OF FRANKLIN ZWEIG, PH. D., J.D., CONSULTANT FOR GOVERNMENT RELATIONS AND PUBLIC POLICY, AMERICAN ASSOCIATION OF COLLEGES FOR TEACHER EDUCATION, AND CHAIRMAN, DOCTORAL PROGRAM, COLLEGE OF HUMAN SCIENCE & SERVICES, UNIVERSITY OF RHODE ISLAND, ACCOMPANIED BY ROBERT W. MacMILLAN, PH. D., DEAN, COLLEGE OF HUMAN SCIENCE & SERVICES, UNIVERSITY OF RHODE ISLAND

Mr. ZWEIG. Thank you, Mr. Chairman.

I would like to, on behalf of the AACTE, thank you for permitting us to share our views today.

I would like to introduce helping with our presentation today Dr. Robert MacMillan to my right, the dean of the College of Human Science and Services at the University of Rhode Island.

Chairman STARK. Nice to have you.

Mr. MACMILLAN. Thank you.

Mr. ZWEIG. Dr. MacMillan presides over a teacher training institution of some magnitude and is an active member of the association's work.

The association represents 722 schools, colleges, departments of programs of education. We are responsible, for better or worse, for about 87 percent of all new teachers annually who leave at the baccalaureate level from accredited schools.

There are about 270,000 students currently enrolled in education courses, Mr. Chairman, and schools of education have contacts with about 200,000 to 500,000 currently employed teachers in a continuing education enterprise which is startling for its size.

We want to commend you. The association is very pleased that you, Mr. Chairman, offered your measure at this time.

We wish to point out that you offered it during a time of severe retrenchment in Federal education programs and policies and we believe that your measure could offer an important peg in filling the gap left by reduced funds and changes in the direction——

Chairman **Stark**. It is called supply side education.

Mr. **Zweig**. We appreciate supply side in that context, Mr. Chairman.

We think that your measure is timely for another important reason that none of the witnesses has mentioned so far, so this gives us a chance to bring fresh item on the agenda.

The National Center for Education Statistics anticipates that between 1984 and 1990 due to the baby boom—that is the second generation of the post-World War II baby boom—and due to immigration, legal and not, we will face a significant teacher shortage in this country.

We have always had shortages in special areas, special areas of the country, special subject matters, such as science and math, but we appear to be staring in the face a general teacher shortage which NCES feels will be on the magnitude of a 20 percent under supply in the year 1988.

For that reason the marriage of technology and education, we think, has special significance, particularly if we can provide for those new teachers and those teachers who will be returning from an oversupply status back to teaching with the technical skills to utilize that technology in the classroom and in the development of curricula.

We wish to underscore that your bill also comes at a time that science education virtually has ground to a halt in this country. We may go beyond some of the other witnesses in our estimates of that, but we believe this halt is frustrating all of our trade productivity and defense objectives.

Linking high technology to education is essential and the use of the tax law in this regard we believe to be intriguing.

Our members inform us of two major obstacles to utilizing technology in the classroom, one is that the teachers of teachers are insufficiently prepared to succeed really in a new teachers career, a style and comfort and literacy in utilizing high technology.

A second problem is training the average teacher who has about 7 years; the average teachers have been on the job about 7 years, training that person to adopt a new teaching style.

Based on these objections, we respectfully suggest consideration of a few additional items to H.R. 5573 which we believe will improve its effectiveness.

First, we would be hopeful that you might include schools, departments, and colleges of education as directly eligible beneficiaries from donors within the ambit of this bill.

We realize that there is a research deduction available for the donation of scientific equipment, but we feel that—we are concerned that there is an exclusion for training purposes in order to realize that deduction.

Second, we respectfully suggest that courseware be eligible property for purposes of this bill.

Third, we believe that it would help the utilization of technology if allowable expenses independent training and technology transfer be tax creditable.

Fourth, we believe it would help Federal education policy if donors could realize enhanced incentives by donating to schools serving high concentrations of poor and minority children.

Fifth, we would hope that it might be possible to make an exception for education technology purposes to section 174 of the IRS Code which currently excludes social science and humanities research.

Mr. Chairman, we would be very pleased to cooperate with your staff and yourself in this regard and we thank you for the opportunity to testify and for your leadership on this matter.

[The prepared statement follows:]

STATEMENT OF FRANKLIN M. ZWEIG, PH. D., J.D., CONSULTANT FOR GOVERNMENT RELATIONS AND PUBLIC POLICY, AMERICAN ASSOCIATION FOR COLLEGES OF TEACHER EDUCATION, AND CHAIRMAN, DOCTORAL PROGRAM, COLLEGE OF HUMAN SCIENCE & SERVICES, UNIVERSITY OF RHODE ISLAND, AND ROBERT W. MACMILLAN, PH. D., DEAN, COLLEGE OF HUMAN SCIENCE & SERVICES, UNIVERSITY OF RHODE ISLAND

The Hon. Fortney Stark, chairman, and distinguished members of the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives:

Mr. Chairman and members of the committee, it is a great privilege to appear before this distinguished Committee today and to represent the large majority of institutions providing pre-service and in-service teacher education for the nearly 45 million American children attending elementary and secondary schools in the nation's 16,000 public school districts. It is estimated that 2.4 million teachers currently are employed in our 88,000 tax-supported elementary and secondary schools and in approximately 14,000 non-public schools.[1]

The American Association for Colleges of Teacher Education is comprised of 722 member schools, colleges and departments of education located in the Nation's institutions of higher education. We train 87 percent of the Nation's new teachers. We provide many forms of continuing education and in-service training to nearly 500,000 teachers a year. We estimate that 275,000 undergraduate students preparing for teaching careers currently are enrolled in our member colleges of education.

Before proceeding, Mr. Chairman, we wish to commend you for the farsighted and constructive legislation you have introduced. H.R. 5573, the Technology Education Act of 1982, is being considered at a time of enormous ferment and change in education; a time of vigorous searching for re-establishment of adaptive, quality education in service to the economy; a time of searching re-examination of education in American priorities; a time for forging new social goals and public policies in order to invest effectively in the creation of human capital.[2]

This initiative, Mr. Chairman, is an important perspective in the modernization of education. If this measure succeeds, as we believe it will, in establishing the potential uses of high technology as an essential ingredient of that modernization, it will have performed an historic and crucial role in American education.

We wish to underscore, moreover, the potential of H.R. 5573 for stimulating enterprise initiative in conjunction with our Nation's educational institutions and professions. The need for closer connections, joint ventures and partnerships between the private sectors and the schools has been receiving much attention. In 1979, the Committee on Labor and Human Resources of the U.S. Senate began systematic examination of collaborative potentials in Hearings entitled "Higher Education and the Workplace".[3] Witness after witness at those hearings stressed the need for better fit between employers and educators, and new technologies were identified as one important means for achieving it. Such examinations are proceeding at State and local levels as well. In March of this year, for example, the New England Board of Higher Education issued an landmark policy entitled "A Threat to Excellence".[4] That report identified the costs in lost opportunties between education and the private sector—particularly but not exclusively high technology goods and service producers—to the Nation's most knowledge intensive region.

---

[1] National Center for Education Statistics, The Condition of Education, 1980 Edition, Table 2.1, U.S. GPO, 1980, p. 57.

[2] Committee on Science and Technology, U.S. House of Representatives, Survey of Science and Technology Issues, Present and Future, 97th Congress, 1st Session, June 1981, p. 35-59, 123-142, 217-224; Eli Ginsburg and George J. Vojta, "The Service Sector of the U.S. Economy", Scientific American, March, 1981; Chauncey Starr and Philip C. Ritterbush, Science, Technology and the Human Prospect, New York, Pergamon Press, 1980, esp., p. 129-185.

[3] Committee on Labor and Human Resources, U.S. Senate, "Higher Education and the Workplace", Hearings before the Full Committee, June, 1979.

The Technology Education Act could not be more timely. There is currently in evidence widespread concern for improved educational quality and excellence. One stream of that concern relates adoption and utilization of technology as a potentially useful, cost-effective means of raising quality standards, methods and impact indicators. These themes can be found in recent hearings on educational excellence conducted by the Hon. Paul Simon, Chairman of the Subcommittee on Postsecondary Education of this Body. Such themes are directly reflected as well in the BEST (Basic Education Skills through Technology Program) launched in the Department of Education by Secretary Terrill Bell. Moreover, Mr. Chairman, popular interest in the technology revolution has emerged to an extent unforecast a few years ago. Videogames will rival commercial films for expenditures made by the consuming public this year. Home computers are the hottest items on the mass markets. Our mass circulation media have captured repeatedly the public's interest in computer-assisted play and technology-augmented education.[5]

These trends make themselves felt at a crucial time for other reasons and lend special urgency to consideration of your bill, Mr. Chairman.

Federal policy with respect to education is in a state of rapid flux, some will say disarray. For example, Federal aid to promote educational innovation (programs authorized by Chapter II of the Education Consolidation and Improvement Act of 1981, so-called education block grants for the States) will be cut by an estimated 60 percent in Fall, 1982, from their appropriated levels of fiscal year 1981.

Federal aid to educationally disadvantaged children, the programs of direct assistance of local educational agencies and non-public schools, is fiscally stressed by Federal budgetary constraints at a time of massive local financial shortage. Facing severe hardship and teacher layoffs in the most problems impacted areas—inner cities and rural areas—the prospects for educational improvement are dimmed by programmatic cutbacks and schools closings.

While education's currently experienced stress partly results from reduced enrollments stemming from declining birthrates, the National Center for Educational Statistics estimates the Nation faces a general teacher shortage in the period beginning Fall 1984 and continuing through the end of this decade.[6] That general shortage is attributed to a host of factors, but prime among them is the so-called "echo" of the post World War II "baby boom", the second wave of the unprecedented birthrate of the 1950's and early 1960's. Add to that "echo" the waves of immigration, legal and illegal, the Nation now experiences and we can expect a shortage for which our schools totally are unprepared.

There is constantly a teacher shortage with respect to some subject areas, some population groups, some regions of the Nation. The facts of these shortages are commonly known, but two or three instances have become nothing short of National scandal and crisis: science and mathematics education, most salient for educational technology, virtually has ground to a halt as against our National needs and objectives; occupational, vocational and adult education experiences completely inadequate instrumentation and equipment; the number and proportion of secondary school teachers has evidenced steady reduction, portending further erosion of science and mathematics and vocational education as well as other subject areas as the school population inclines in the second half of this decade.[7]

It is estimated that 15 percent of all public schools now have some kind of computer hardware, but our anecdotal information indicates that much of that capacity sits idly on supply shelves and in equipment closets because teachers do not know how to use it.[8] After an initial interest in the hardware, it becomes a useless fixture under such circumstances. The usual processes of technology transfer under such conditions could backfire, resulting in wholesale rejection of such technology by the people who should depend upon it most, our classroom teachers. The rejection of educational technology by balky educational delivery systems could set back educational modernization for years.

---

[4] New England Board of Higher Education, A Threat to Excellence: The Preliminary Report of the Commission on Higher Education and the Economy of New England, March 1982.

[5] "Games that Play People", Time, January 18, 1982, p. 50; "Here Come the Microkids", Time, May 3, 1982, p. 50.

[6] NCES, supra, p. 73.

[7] NCES, supra, pp. 25-35.

[8] "Computers Widely Used in Schools", New York Times, May 2, 1982, p. 1.

Our member colleges, Mr. Chairman, report that the biggest obstacle to adoption of educational technology is absent and inadequate software. Discouragement with the quality and sophistication of educational courseware is widespread. We are aware that some companies are expending significant effort and money to remedy the courseware gap. If it cannot be remedied soon enough to apply computer hardware meaningfully in the classroom, of course, the rejection of educational technology by established education, ill-prepared delivery systems could be enhanced.

Moreover, schools of education, hard pressed financially as is all of higher education, have had inadequate opportunity to explore and apply computer technology in teacher education. If the teachers of teachers are unable to include such technology in a signficant way in their educational delivery, the faucet of educational change and improvement is turned off at its source. Teacher preservice and inservice education desperately needs hardware, network access, software, computer literacy, and evaluative research resources. Such provision could be the means by which the education profession can best rally to the potentials of technology. This is especially true for the near future in which newly educated and returning teachers will be hotly pursued to remedy the 20 percent shortfall in teacher supply expected by 1988.

In short, Mr. Chairman, American education is "out of synch" as between its needs and resources, and as between the Nation's priorities and prospects. Educational technology could help remedy the situation by capacitating education resources to meet educational needs more effectively. Educational technology could reinforce our science and mathematics education and our programs of technical study. But will it? Certainly not be terms of Federal budget policy. The Federal budget, for example, effectively ends the science education program of the National Science Foundation. State budget policies offer little more hope; expenditures for technology transfer in times of financial hardship understandably are viewed as luxury.

Your effort to synchronize educational needs and resources with technology as set forth in H.R. 5573 depends upon tax policy. This is a new and an intriguing policy direction for education professions and associations. As you know, utilization of tax policy for general education support through tuition tax credits is strongly opposed by many, including this Association, because it risks reduced support of or system of public education. While imperfect in many respects, that system brought the Nation to our highest levels of literacy and educational attainment in our history.[9] We do not wish, therefore, to signal our interest in your bill as a general endorsement of tax policy for other educational purposes.

With that caveat, Mr. Chairman, we respectfully suggest a few additions to H.R. 5573. In our judgment, five modest changes would place the measure in a more favorable position to address the issues interfacing technology and education discussed earlier.

1. The bill should include accredited colleges, departments and schools of education as eligible recipients of technology property eligible for donor tax credits.
2. The bill should permit the inclusion of software and courseware as eligible technology property qualified for tax credits according to standards and schedules to be specified.
3. The bill should permit the donation or purchase of services dedicated exclusively to the processes of training and technology transfer as expenditures qualifying for tax credits.
4. The bill should augment Federal education policy—providing access, equity and quality improvement for the disadvantaged—by including preferred incentives for companies donating hardware and software to schools with high concentrations of poor and minority children.
5. The bill should create an exception to research and development tax credits exclusions of social science and humanities research established within Section 174 of the Internal Revenue Code of 1954 as amended by the Economic Recovery Tax Act of 1981 so that educational technology development would be encouraged in joint ventures created by education and private enterprise.

Mr. Chairman, we believe that the thrust of your legislative initiative in the Technology Education Act of 1982 would be aided by these ideas. The technical requirements of the suggested additions to your legislation can be met with least possible additional cost.

---

[9] Census Bureau, U.S. Department of Commerce, Bulletin No. 12 for the 1980 Census, "Educational Attainment," released Apr. 2, 1982.

We urge your consideration as your work progresses. We stand ready to assist you and your staff.

We thank you for your progressive and constructive legislative leadership.

We are most grateful for the opportunity to present views on behalf of the Nation's colleges and schools of education.

Chairman STARK. Thank you, Dr. Zweig.

You raised a good point. There was no particular intention of excluding equipment in the training of teachers and I think it is a point well taken.

Mr. ZWEIG. If it is possible to do it, we think it would help the general thrust and intention of your bill.

Chairman STARK. Thank you very much.

Mr. Kruse.

STATEMENT OR RICHARD KRUSE, DIRECTOR OF GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF SECONDARY SCHOOL PRINCIPALS

Mr. KRUSE. Thank you, Mr. Chairman.

Members of the distinguished committee, thank you for the opportunity to allow me to come before you today on behalf of the 34,000 public and nonpublic secondary school principals and headmasters who make up our National Association of Secondary School Principals.

Mr. Chairman, we stand with you in strong support of H.R. 5573, the Technology Act of 1982, and wish you well and wish to work with you in achieving its ends.

As you know, Mr. Chairman, there is a veritable explosion of new technology coming from the public and private sectors which is changing the workplace overnight.

The skills and experiences necessary to compete in the national and increasingly international workplace center around computer literacy. Somehow we must equip our classrooms, train our teachers, and upgrade curricula to meet these demands.

The Technology Act of 1982, we believe, is a beginning. I would lend one word of caution and that is one computer in each school doth not a computer literate society make.

Needless to say, the cost of retooling our schools with the appropriate hardware, software, training of our teachers, and maintaining equipment will be very, very high.

If we wait for school districts, State Departments of Education and Governors to raise the funds to retool classrooms, we may have a long wait since our school districts budgets in particular are in very dire straits.

But, if we opt to provide the short-term tax incentives to industry to donate hardware to our schools, then Government and industry, we believe, can share the costs of this initial retooling.

The task of equipping our schools with computers will be a monumental task and perhaps will not be achieved for many years, but we must begin and this bill will make that possible.

Schools must be the top priority, we believe, in investing our Nation's great wealth.

Second, the Technology Act of 1982 does not require a bureaucracy nor would it require a lot of regulations to administer. This is a luxury that would be lost if the measure were a spending bill.

Third, there is an important precedent for an expansion of the charitable income tax deductions as mentioned by the other witnesses today.

Corporations are currently allowed to donate scientific equipment for colleges and universities under section 170(e)(4) of the Internal Revenue Code of 1954 and they can deduct the cost of a donated piece of property plus one-half of the wholesale markup, not to exceed twice the cost of manufacturing.

We suggest that the elementary and secondary schools play an equally vital role as our sisters in higher education and they should enjoy the same benefits.

Expansion of the permissible percentage of taxable income deduction from 10 to 30 is justified, we believe, by the immediate need for new equipment in our schools.

Fourth, we recommend that nonpublic schools be explicitly mentioned as an eligible recipient of these donations of computers.

Our nonpublic schools play a vital role of educating 11 percent of the children. Incidentally, I am under the impression that, based on the definition of educational organization, they would in fact be part of the program, but we think it would be good to explicitly mention them.

Fifth, for those who are concerned with the question of software compatibility, I can only say that many schools which have begun incorporating computers into their educational programs have done so with an assortment of computers. I can cite three examples for you. We are under the impression that the Dallas Independent School District has 20 TRS-80's, 8 Ataris, 1 Heathkit, 1 Apple computer, and 1 Texas Instruments computer.

They have made those purchases with some forethought.

Two, the Community Consolidated School District No. 59 in Arlington Heights, Ill., has in fact three Apple computers, one Alpha computer, and one Midwest Scientific computer.

Finally, School District 196 in Rosemont, Minn., which I understand has made some great strides as a State in this regard, has 33 TRS-80, and 3 Apple II computers.

So the point is that school districts and personnel can deal with the different types of hardware available and we trust that in fact with the hardware we will come into plenty of software, this being a new market for the software companies.

I want to thank you for allowing us to appear and I would be happy to answer questions.

[The prepared statement follows:]

STATEMENT OF RICHARD A. KRUSE, ASSISTANT DIRECTOR FOR GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF SECONDARY SCHOOL PRINCIPALS

Mr. Chairman, members of this distinguished committee, my name is Richard Kruse, and I am the Assistant Director for Government Relations for the National Association of Secondary School Principals. On behalf of the 34,000 middle, junior and high school principals and assistant principals who make up the NASSP, I want to express our strong support for the "Technology Act of 1982" (H.R. 5573).

We view this measure as an exciting opportunity for the federal government, business, industry and the nation's schools to join forces in meeting the rapidly expanding high technology demands on our workforce. I must say these demands are great considering a recent news release distributed from the Department of Labor stating that overall employment in the computer technology fields is expected to double by 1990. As a nation, we can hardly afford to allow our schools to be without the instrument that will play a dominating role in tomorrow's work place. We see this bill, Mr. Chairman, not so much as a tax break to industry, but rather as a significant investment by business and government into the nation's educational capital. This investment is but an initial step in re-tooling our schools with the technology that is an inevitable part of our future. Not only will this measure assist in re-tooling our schools, it will do so without requiring a huge bureaucracy, and without a myriad of over-restrictive regulations which have plagued our schools in the past. The bill requires that schools provide assurances that donated equipment will be used for educational services, and that schools won't sell or exchange the property. These requirements are simple and acceptable.

We understand that some critics of this proposal will cite the imcompatibility of different software for different computers. We don't view this as a problem, as we have contended with similar incompatabilities in the '50s with 8 mm and 16 mm film projectors, and in the '70s with one-half and three-quarter video tapes. Unlike either of the above, a computer can be reprogrammed to fit the needs of its user. Furthermore, we believe that computer manufacturers will respond to this sudden infusion of hardware in our schools by developing innovative education programs designed for a wide range of educational uses.

We would caution the Committee that one computer in each school doth not a computer literate society make, but it is indeed a beginning, and a beginning that is affordable.

We suggest two changes in the bill—one, to explicitly include nonpublic schools as eligible for charitable gifts of computers. We understand that they would not be precluded by the current tax code definitions of an educational organization, but to be explicit in this area would be helpful. Two, because the dynamics of the computer industry quickly leads to obsolescence, we suggest that the charitable contributions of hardware to schools be made within one year after the date of manufacture of the property.

The Administration has stated its opposition to this measure because it would "benefit only a very few taxpayers." This is true on one side of the equation—the computer industry is benefitted—but it is totally untrue on the other side of the equation. The true recipients of this measure are the elementary and secondary students who will be granted an opportunity (perhaps early on a limited opportunity) to appreciate the growing uses of computers in our society.

Thank you for the opportunity to express our support for this legislation. I'll be happy to answer any questions.

Chairman STARK. Thank you.

I just wanted to make one comment on your testimony. The idea of one computer in each school is not really part of the bill. That was mentioned by one of the potential donors.

Mr. KRUSE. In fact, Mr. Chairman, I think I recall——

Chairman STARK. Mentioned as something they would be willing to do. I think the reasoning behind that—certainly I don't want to put words in their mouths—was to make sure that every school gets a chance to get at least one. I just wanted to clear up any misunderstanding.

The bill makes no reference to how this equipment might be distributed.

Mr. KRUSE. I understand. The only reason I mentioned that is, we wanted to try to emphasize the fact that we have a long way to go here and this is a wonderful start.

Chairman STARK. Thank you.

Ms. Page.

STATEMENT OF RAYMA C. PAGE, PRESIDENT, NATIONAL SCHOOL BOARDS ASSOCIATION

Ms. PAGE. Yes, sir.

Thank you, Mr. Chairman. I am Rayma Page and I am currently the president of the National School Boards Association. I am also chairman of the Lake County, Fla., school system.

We have 31,000 students. I am beginning to think that this light system up here would be very valuable at home as the chairman of the school board.

I am really pleased to have this opportunity to share some of the National School Board thoughts with you.

The National School Board is the only major educational organization representing this Nation's 95,000 local school board members, and as local officials we are responsible for educating as well as providing other services for more than 40 million young people in the United States.

Since most of our members are elected and politically accountable for both public policy and fiscal management, school board members like other elected officials address public policy without consideration to professional vested interests.

It is now painfully apparent to most Government leaders, business executives, and professional educators that the future success of the United States is absolutely linked to our capacity to compete in an increasingly technological world.

This Nation's commitment to invest in human capital is fundamental to our capacity to be competitive regardless of whether it is the human skill necessary to develop new technologies, to fill jobs, or to simply make the best use of the information available in the marketplace.

The investment in human capital must begin in the public schools.

In this regard, computers as one form of technology offers the public schools the opportunity to diversify their curriculum, individualize instruction, more efficiently use the time of classroom teachers, and better prepare students to meet the challenges of the world waiting for them in the next 5 to 10 years.

Unfortunately, public schools are not in a position to assume the exclusive responsibility for the application of those and other technological advances.

While local school systems expend over $100 billion per year, typically 75-80 percent of those funds are utilized for the employment of personnel, with the remainder allocated to debt service, energy costs, the maintenance of programs, and the other obligations of operating a local school system.

The point, is in the face of a 14-percent cutback in Federal education dollars over the past 2 years, with an expected reduction in real State funding next year, and with tax limitation laws capping local revenue raising in many States, local school boards, in adopting their budgets, are attempting to hold on and simply cannot afford a major financial investment in computer hardware.

Accordingly, in view of the need for computers in the school setting, and in recognition that school systems cannot afford to expend approximately $2,500 per computer unit in a way that can adequately, or equitably, serve 16,000 different school systems, 100,000 school buildings, over 2 million classrooms, and 40 million schoolchildren, we believe the enactment of this legislation is both timely and in the national interest.

As a school board member, I have a few suggestions that will help implementation, I believe, of your bill.

First, section 2 of the bill limits school systems to use the donated computers exclusively for the direct education of students. We do not know the kind of accounting or auditing that this provision might entail for local school systems.

However, we urge consideration be given to insure that the statement required of local school systems in clause (vi) not be interpreted to imply detailed bookkeeping requirements, especially since over 100,000 pieces of equipment may be involved.

More importantly, why restrict the use of hardware to direct educational activities? Why not permit school systems to use the hardware in ways which make more efficient use of total school system resources, especially if such other uses are limited to nonschool hours?

In this regard, we would suggest amending clause (iv) of the proposed revisions to subsection 170(E)(5)(B) by striking the words "all of the use" and substituting in lieu thereof the words, "provided that during school hours the primary use," of which by the donee is directly in the education of students in the United States.

Second, in order to insure the expeditious use of the hardware, we suggest adding a provision to enable the donation to be accompanied with the appropriate installation, training, and other related startup services.

We wish to take issue with a point raised by the Department of Treasury. In testimony before the U.S. Senate, Treasury raised the concern that, absent Federal regulation, manufacturers might be inclined to allocate hardware to those attendance areas in which families would have the financial means to purchase computers for home use.

At the outset, it should be recognized that the school system, not the manufacturers, will determine the allocation of hardware.

In this regard, while the manufacturer may wish to approach individual school buildings, the terms and conditions of donations are subject to school board policies, which usually involve centralized clearance procedures.

Therefore, Treasury's concern over the manufacturer's desired placement of the computers, as with any donation, should be allayed by school board and central administration policies.

Mr. MATSUI. Excuse me. Is that correct? It has been my understanding—I could be mistaken—that the computer company has the sole discretion to give whatever equipment it wants to whatever school it chooses.

Please correct me if I am wrong about that. This equipment doesn't go to the school district. I am aware that the school district has the ability of negotiating for this computer equipment, but it is my understanding that these computers go to the individual school and the computer company would have the sole discretion to give it to whichever school it desires.

That dealt with Mr. Chapoton's point in his testimony.

Ms. PAGE. My answer would be that if anyone came into my county and wanted to donate computers to any local school, there would be no principal that would accept those computers without it first being cleared by the administration and the school board, because it is going to require in-kind funds and a lot of other things and it is the school board's responsibility to supply not only the funds, but the leadership.

Mr. MATSUI. I agree. That may well be your position and your trustees may be strong in origin to withstand that kind of pressure. I would commend you for that stand because I think that is the way it should be, but I can envision some school districts in which public pressure or other circumstances may result in situations where an individual school would be unable to resist such pressure.

I support this bill completely and I would like to prevent this situation from occurring. For this reason I am wondering if we could say your statement is accurate across the board on that.

In your situation, that may well be the case, but I would like to see some tightening of that if at all possible. If we can't, we may have to live with it.

I don't want to see the bill hurt. At the same time, I would like to see that situation tightened. Perhaps during my further questioning of you, I along with the other members will go into this matter in greater detail, but I wanted to raise it at this time.

Ms. PAGE. That relates directly, Mr. Matsui, to the assumption made earlier, or the comment made by someone who testified earlier, that there is a possibility that the computers might be placed in the homes of the more affluent neighborhoods with the idea that the parents could afford the components for their own homes and then all students would not be subject to learning how to use a computer.

That is something that the National School Boards Association would definitely take issue with because we are responsible for educating all children, not just children in wealthy districts.

Mr. MATSUI. I understand that. I understand your position but my concern which I could discuss with other members of the panel later, is that some States may not share your feeling for justice and equity.

I would like to discuss that possibility at the appropriate time.

Ms. PAGE. I am sure we could provide you with information that would give you some idea of the responsibilities, as well as the laws of the States, that would tell you whether those States have that authority, whether the school systems have that authority locally.

It is my understanding that you will find most of them do. But it is a good point to look into and we will provide you with that information.

Mr. MATSUI. Thank you.

Ms. PAGE. I think in our discussion, I have covered the rest of what I wanted to say that we do not want to see the computers placed in areas where not all students have a chance to look at them, and we feel in considering the legislation, we would urge the committee to consider the diversity in the size of the Nation's school systems. Particularly the diversity in the size of school buildings as well as diversity in concentration of specific student needs within these buildings.

If local school systems are going to make effective use of donations, they should have the flexibility to determine where to place the equipment. That is, if the committee decides to limit the number of donations allowable to a school system, the Federal law should not regulate how or where the school systems use the equipment. Again, that addresses your issue.

I want to stress that we highly support H.R. 5573, it serves an area of national need which requires Federal legislation and in behalf of the Nation's largest association of elected officials in the United States, it is our privilege to be able to have input into your deliberations today and we appreciate that opportunity.

[The prepared statement follows:]

STATEMENT OF RAYMA C. PAGE, PRESIDENT, NATIONAL SCHOOL BOARDS ASSOCIATION

My name is Rayma C. Page, and I am President of the National School Boards Association. I am pleased to have this opportunity to testify before the Subcommittee on Select Revenue Measures. The National School Boards Association is the only major education organization representing the nation's 95,000 local school board members. These local officials, in turn, are reponsible for educating, as well as providing other services to more than 40 million of the nation's citizens.

Currently marking our 43rd year of services, NSBA is a federation of state school boards associations, with direct local school board affiliates, constituted to strengthen local control of the legislative authorities and responsibilities and to work for the improvement of education. Most of our members are elected. Accordinlgy, they are politically accountable to their constituents for both public policy and fiscal management. As elected officials, school board members, like other elected officials, address public policy without consideration to professional vested interests.

INTRODUCTION—STATEMENT OF NATIONAL NEED

On behalf of the nation's 95,000 local school board members, and the 40 million public school children whom we are reponsible to educate, I want to thank you for this opportunity to testify on H.R. 5573.

It is now painfully apparent to most government leaders, business executives and professional educators that the future success of the United States is inextricably linked to our capacity to compete in an increasingly technological world. This nation's commitment to invest in our human capital is fundamental to our capacity to be competitive—regardless of whether it is the human skill necessary to develop new technologies, to fill jobs, or to simply make the best use of the information available in the market place. The investment in human capital must begin in the public schools. In this regard, computers, as one form of technology, offer the public schools the opportunity to diversity their curriculum, individualize instruction, more efficiently use the time of classroom teachers, and better prepare students to meet the challenges of the world that will be waiting for them in the next five to ten years.

Unfortunately, public schools are not in a position to assume the exclusive responsibility for the application of those and other technological advances. While local school systems expend over $100 billion per year, typically 75-80 percent of those funds are utilized for the employment of personnel—with the remainder allocated to debt service, energy costs, the maintenance of programs—and the other obligations of operating a local school system. The point is, in the face of a 14 percent cutback in federal education dollars over the past two years, with an expected reduction in real state funding next year, and with tax limitation laws capping local revenue raising in many states, local school boards, in adopting their budgets, are attempting to "hold on" and simply cannot afford a major financial investment in computer hardware.

Accordingly, in view of the need for computers in the school setting, and in recognition that school systems cannot afford to expend approximatley $2,500 per computer unit in a way that can adequately—or equitably—serve 16,000 different school systems, 100,000 school buildings, over 2 million classrooms, and 40 million school children, we believe the enactment of this legislation is both timely and in the national interest.

SUGGESTED REVISIONS TO H.R. 5573

NSBA does, however, have a few minor suggestions which we believe will improve the implementation of the bill.

First, section 2 of the bill limits school systems to use the donated computers exclusively for the direct education of students. We do not know the kind of accounting or auditing that this provision might entail for local school systems. However, we urge consideration be given to ensure that the statement required of local school systems in clause vi not be interpreted to imply detailed bookkeeping requirements—especially since over 100,000 pieces of equipment may be involved. More importantly, why restrict the use of hardware to direct educational activities? Why not permit school systems to use the hardware in ways which make more efficient use of total school system resources—especially if such other uses are limited to non-school hours? In this regard, we would suggest amending clause (iv) to the proposed revisions to subsection 170(E)(5)(B) by striking the words "all of the use" and substituting in lieu thereof the words, "provided that during schoool hours the primary use", of which by the donee is directly in the education of students in the United States.

Second, in order to ensure the expeditious use of the hardware, we suggest adding a provision to enable the donation to be accompanied with the appropriate installation, training, and other related "start-up" services.

POSITION TAKEN BY U.S. TREASURY

We wish to take issue with a point raised by the Department of Treasury. In testimony before the U.S. Senate, Treasury raised the concern that, absent federal regulation, manufacturers might be inclined to allocate hardware to those attendance areas in which families would have the financial means to purchase computers for home use. At the outset, it should be recognized that the school system, not the manufacturers, will determine the allocation of hardware. In this regard, while the manufacturer may wish to approach individual school buildings, the terms and conditions of donations are subject to school board policies—which usually involve centralized clearance procedures. Therefore, Treasury's concern over the manufacturer's desired placement of the computers (as with any donation) should be allayed by school board and central administration policies.

Further, it should be recognized that school systems for decades have purchased equipment that can attract home use. Based on the history of those usages, and given the responsibility of local school boards as governance bodies, it is incomprehensible that the school systems would select attendance areas or enroll students on the basis of family wealth. Further, it should be recognized that 10,724 or 69 percent of the nation's 15,602 school systems have four or fewer buildings—most of which include elementary, junior and senior high schools. At least for those school systems, Treasury's point that school could be selected on the basis of wealth has no applicability. On the other hand, large urban school districts have large numbers of low-income families. But, these systems understand that there capacity to educate disadvantaged children is one of the most challenging educational issues confronting public education today. In view of this challenge, as well as the political pressures on local school boards, it is inconceivable that these donations would be utilized to augment the curriculum offerings of wealthy school areas—to the exclusion of unfilled needs in lower income school areas.

LOCAL SCHOOL DISTRICT FLEXIBILITY

Lastly, in considering this legislation, we urge the committee to consider the diversity in the size of the nation's school systems (e.g., the number of buildings per system), the diversity in the size of school buildings, as well as the diversity and concentration of specific student needs within those buildings. If local school systems are going to make effective use of their donations, they should have the flexibility to determine where to place the equipment. That is, if the committee decides to limit the number of donations allowable to a school system, the federal law should not regulate how or where the school systems use the equipment—except for the limitation we suggested for clause iv.

CONCLUSION

In conclusion, NSBA is highly supportive of the intent of H.R. 5573. It serves an area of national need which requires federal legislation. On behalf of the nation's 16,000 local school boards, NSBA is prepared to assist the committee in any way we can to facilitate the enactment of this legislation.

Chairman STARK. Thank you very much.

Mr. Matsui?

Mr. MATSUI. Thank you, Mr. Chairman.

I would like to ask the panel members as a whole, basically two questions, one of which I asked Mrs. Page regarding how you insure that these computers are distributed equitably within a particular school district or school area so that this equipment doesn't go exclusively to the wealthy schools while other schools are left out.

Second, how do you maintain some control over the kind of equipment that ultimately is delivered?

I know that Apple promised to give every school in the country a computer in the next 12 months if the bill is passed.

That may solve the problem, as a contract or letter could be sent to Apple or they could send a letter to us. I am sure they would in good faith carry out that agreement.

But how can we be assured these computers will be equitably distributed?

Second, how do you think you could control the kind of equipment that will be given?

I think since the Government will be involved in the sense we will provide a tax break, we should be certain that only that equipment which is best suited for the children's needs should be donated.

Again, I believe in all the concepts we talked about in terms of high technology, but now I want to talk about the specifics of how we can implement the bill in a fashion that we, in fact, serve these needs that we are discussing.

Ms. PAGE. School boards have the same concern as the gentlemen on both sides of me here. We are concerned over the training of teachers to teach the use of computers.

We are concerned with the fact that the person in the school system, the most important person, is—outside of the superintendent—the building principal. I am looking, for instance, at a school of 2,000 and you only put one computer in there, you won't make a terribly big dent even in the United States.

There is only so many hours, 180 days approximately, a year, and that those students are going to have access only in that time.

I am quite sure that if this takes place, there would certainly be cooperation among all the education groups to see that the best use would happen.

Mr. MATSUI. Thank you.

Mr. ZWEIG. The point you raise, Congressman, is an excellent and a difficult one and it has faced Federal decisionmaking ever since the Federal Government has generated educational policy.

The question is to what end should the Federal policy be directed? Who is going to be the primary and who are the secondary beneficiaries of that Federal policy?

It may be that the committee, either in the statutory text or in the report language, will have to make some decisions on that matter.

Our association suggests that an enhanced incentive be given to donors who follow suit with Federal education policy adopted in the Elementary and Secondary Education Act.

That is, that schools hosting higher proportions and concentrations of poorer and minority children be given preference in the sense that would not preclude any producer from giving to any school, but if there could be an additional incentive to provide equipment—and we hope, also, courseware—for those schools least able to buy and which provide the greatest problem in terms of financing for the local school boards in many respects, that Federal education policy would be met and that consistency would follow.

Mr. MATSUI. What about the issue of the equipment itself? You, obviously, will have some ability to negotiate by refusing this equipment, in which case the company wouldn't get its tax deduction. From this perspective, you have some leverage.

In most cases, however, the donor has more leverage than the recipient because, especially in the coming years, people in your position will have difficult times ahead in terms of capital expenditures.

You will probably take whatever you are offered.

How do you tell someone—or how can we to help improve this legislation and guarantee that the equipment donated is the equipment that is of the highest quality and best suited for your students?

Mr. ZWEIG. There is only one way, Congressman, and that is to provide a sufficient orientation, sufficient training base for the people who have to make the decisions that they can choose wisely according to the needs that they perceive in each school and in each school district.

If one goes into a computer store today to buy a piece of equipment, the confusion is virtually overwhelming until a certain period of sophistication develops where different needs of the purchaser and different potentials of the different equipment sort of come together and one of the reasons that the Association of Colleges for Teacher Education feel that the donations or purchase of training incident to this bill is important is so that the recipient can be selective and target what is still a limited——

Mr. MATSUI. Right. I think maybe I didn't ask you a clear question. I can only think—you will have to excuse me—of the difference between an Atari as a 400 or an 800. That is my present level of sophistication, given that my son is involved in it.

Let's look at it this way. If there was an outright grant from the Federal Government of $1,000 or whatever appropriate sum for each computer, school systems could negotiate for this equipment in the open market and buy their own computers in the quantities they wanted, perhaps getting a better deal in the process. In the situation, however, where one company, Atari for example, says I will give you a 400, it is a one-sided deal because the donors will be giving you the equipment and you will receive it.

You have a limited ability to negotiate in that situation for this equipment.

Given the above, how can we improve this legislation to increase your negotiating capability?

Perhaps we can help by putting in restrictions on the kinds of equipment that will be given so that you can get the best kind of equipment.

Mr. KRUSE. If I might chime in on this. I think that we probably should not go ahead and write something at the national level in that regard. I think the school boards will have a policy, some school boards have different policies and allow more autonomy amongst the principals for decisions than others.

But the point is the school district, the boards, certainly would have the right to make a decision as to whether to go ahead and accept a particular item of donation.

Mr. MATSUI. Let me ask you. What if they offer you a hundred Atari 400's, you will take them, right?

Mr. KRUSE. That would be my guess.

Mr. MATSUI. What if you could have done a little better, you know, that is the issue.

In other words, it is an unequal bargaining situation. If you have an outright grant—there will be concerns for the deficit, the issue becomes should we do it by tax expenditure or by appropriation. Mr. Gore raised that issue this morning.

Obviously, we are not going to do it by appropriation because it is too difficult politically to do it that way, that is why we look to the tax expenditures.

Mr. KRUSE. Again, I yield to the school boards to develop the policy and determine what the facts are.

Mr. MATSUI. I find it very difficult to understand the school boards will not be in a strong bargaining position and are going to take whatever the computer companies offer.

You have very limited powers to negotiate in that respect. Maybe in some cases it will be the other way around, in that you can buy the equipment. In most cases, however, you will take what is offered.

Ms. PAGE. Today at every meeting that you go to where anything involving education is discussed, you can see every form of computer, you can sit and learn and you can—this is from the policy standpoint as well as the practitioner—I could see if one computer was donated to the Lee County, Fla., school system that the administration would sit down and decide what school that course or that computer would be placed in and then students would sign up for it and vie for it in that particular case.

Whether we receive money in lieu of equipment, I don't think is nearly as important as the fact that we really need it and the fact we need this help.

Mr. MATSUI. Don't misunderstand me. I believe in the goals and I believe that we obviously need the technology in our school system.

The issue is, are you going to get the most for the dollar that is actually being expended? It is revenue loss. I want to know how——

Ms. PAGE. That is true in anything you do. You don't know, you have to——

Mr. MATSUI. I understand that. I wonder if you have additional restrictions in mind to give the school districts some power in this respect. I don't know how to do that now, but I wonder if it is a problem.

It should be if you don't recognize that it is.

Mr. ZWEIG. You could, Congressman, provide a means to cross-reference your bill to chapter 2 of title V of the Educational Consolidation and Improvement Act adopted in the last year omnibus reconciliation bill.

That is the school improvement chapter. That requires that a plan be generated for the receipt of Federal moneys for school improvement purposes and so long as that plan, which every school district must file, specified the use of technology—and I am sure most will—that might meet the purpose you seek without much further legislative overlay.

Mr. MATSUI. Thank you.

I would like to thank all four of you for being here to offer your testimony.

I thank you very much.

Ms. PAGE. Thank you.

Mr. KRUSE. Thank you.

Mr. ZWEIG. Thank you very much.

Mr. MATSUI [presiding]. I would like to call Mr. Kaloupek and Dr. Pharo, please.

STATEMENT OF DAVID R. KALOUPEK, SENIOR MANAGEMENT AND PLANNING CONSULTANT, INSTITUTE FOR MEDICAL RESEARCH

Mr. MATSUI. Your statements will be submitted for the record, gentlemen. I would like to call at this time Mr. Kaloupek, perhaps you could summarize your testimony at this time.

Mr. KALOUPEK. Thank you, Congressman.

I represent a small nonprofit tax-exempt research organization located in Camden, N.J. We are here today speaking in behalf of passage of H.R. 4667.

As you know, Congressman, the 1981 Tax Incentive Act made special provision for research and development tax incentives to corporations. Section 44(f) of that tax law included a provision which allows a corporation that makes a research grant to a university, a college or an independent research organization, to take a tax deduction, as well as tax credit.

In addition to section 44(f), there is a section 222, which deals with the charitable tax deduction computation method to be used for a corporation's donation of scientific equipment.

That particular provision of the law excluded the small tax-exempt research organizations, which I represent.

The legislation before you today would bring section 222 into conformity with the other sections of the law, section 44(f).

We at the independent research institutes located around the Nation cooperate with the Government by conducting Government-sponsored research, as well as cooperate with universities and colleges in carrying out research projects. We think that the provision of the law which was passed last year under section 44(f) should also apply to section 222 so that the colleges, universities, and the independent research groups would be treated equally.

The recommended change would also help to eliminate some confusion that we find when we deal with corporate contributors.

We urge you to pass this legislation. We are in a phase of our existence whereby we are seeking help from the private sector for basic research and research equipment as we are encouraged to do.

We think that enactment of this particular amendment, H.R. 4667, would eliminate confusion and be very helpful to us in acquiring equipment to carry out our research work.

Thank you.

[The prepared statement follows:]

STATEMENT OF DAVID R. KALOUPEK, SENIOR MANAGEMENT AND PLANNING CONSULTANT, INSTITUTE FOR MEDICAL RESEARCH

Mr. Chairman and members of the committee, I thank you for the opportunity to address you and offer our support for passage of H.R. 4667, an amendment to the Internal Revenue Code of 1954.

My name is David R. Kaloupek. I am senior management and planning consultant to the Institute for Medical Research in Camden, New Jersey. The Institute is a tax exempt and non-profit basic biomedical research facility where nearly 75 scientific and support personnel search for new knowledge to advance the struggle against cancer, birth defects, environmental hazards and aging. Our scientists carry out several biomedical research projects approved and financed by the National Institutes of Health as well as manage and operate two human cell repositories for NIA and NIGMS.

In 1982, the Institute for Medical Research (IMR) has an operating budget of nearly $3.0 million and a funded capital budget of $80,000. Our scientific instruments and equipment budget which we have been unable to fund, requires an additional capital funding commitment of nearly $460,000. The related equipment shortages and absolescence in scientific instrumentation are significant ongoing problems to our research scientists, the Institute and researchers in laboratories throughout the Nation. Based on our experience, the shortfall in equipment has a definite chilling effect on progress in biomedical research.

During the past twelve months, we have launched a concerted effort to interest the private sector—corporations and individuals—in the scientific work of the IMR. We actively seek grants and gifts to support research projects and acquire needed research equipment. It is our hope that the "research and experimentation" provisions of the Internal Revenue Code of 1954 as amended by the Tax Incentive Act of 1981 will provide added incentives for corporations to invest more heavily in our research as well as the scientific activities of all university and independent research organizations.

H.R. 4667

H.R. 4667 is a bipartisan bill which gives recognition to the role of tax-exempt independent research organizations in the conduct of our nation's biomedical research. The bill, sponsored by Messrs. Guarini, Forsythe and their congressional colleagues, will remedy an inconsistency between certain provisions of the existing tax code which deal with corporate grants and equipment donations for basic research.

H.R. 4667 will amend the "research and experimentation" provision of the Internal Revenue Code of 1954. It will include certain tax-exempt organizations such as the Institute for Medical Research, the Salk Institute, Scripps Clinic and Research Institute and Wistar Institute as eligible recipients of donated scientific property for purposes of a special computation of corporate charitable contribution deductions for such property.

TAX INCENTIVE ACT OF 1981

The 1981 Tax Incentive Act included special provisions to stimulate increased corporate investment in basic and scientific research. Section 44F(e) and Section 222 (Sec. 170(e)(4) of the Code) includes provisions for certain tax incentives to corporations which make grants and charitable donations for scientific research performed by public and tax-exempt educational and research organizations.

Section 44F(e) allows corporate taxpayers to take a tax deduction plus an additional tax credit for increased spending for basic research performed by colleges, universities and certain tax-exempt research institutes such as IMR.

On the other hand, Section 222 authorizes a special computation for corporate deductions of scientific property to colleges and universities only. Tax-exempt research institutes such as IMR, Salk, Scripps and Wistar, were not included under Section 222.

Colleges, universities and tax-exempt research organizations carry out nearly forty-nine percent of the nation's biomedical research and development activity.

Many tax-exempt research organizations are affiliated with, but corporately separated from, the colleges and universities of their region. Numerous examples can be cited where independent research institutes, universities, colleges and government jointly carry out and couduct basic research projects and scientific investigation.

There is no apparent reason for continuing to exclude tax-exempt research organizations from the provisions of the tax law. Therefore, I urge you to bring Section 222 into conformity with Section 44F(e).

H.R. 4667, A REMEDY TO TAX LAW INCONSISTENCY

A minor change in the federal tax statute is required to bring Section 222 (Sec. 170(e)(4) of the IRS code) in to conformity with Section 44f(e) of the 1981 Tax Incentive Act. H.R. 4667 provides the necessary statutory language. The change as defined in H.R. 4667 will permit corporations to use the same method of computing their tax deductions when making basic research grants as well as donations of scientific equipment to tax-exempt research organizations, colleges or universities. The current confusion and inconsistency will be eliminated.

The Committee on Joint taxation estimates that the provison will reduce the federal government's fiscal year tax receipts by less than $5 million annually. The estimate was prepared by Mr. Mark McConaghy, Chief of Staff, Joint Committee on Taxation.

RESEARCH EQUIPMENT AND FACILITIES AT IMR

Laboratory instruments and equipment are the scientists' weapons in the war against disease. Technological advances, often very sophisticated and expensive, have made it possible for our researchers to dig deeper into the secrets of life.

At the Institute for Medical Research, the cell is the coommon thread to all our investigations. There are no secrets about the scientific methods used to conquer disease. Scientists, their technicians and aides using instruments and equipment, perform test after test, experiment after experiment, slowly accumlating knowledge about normal and abnormal cells one bit at a time. Through publications, seminars, and lectures, the discoveries are shared with the scientific world.

Modern equipment and accommodations allow our scientists to perform in minutes and days functions that once took hours, weeks and years. The need continues to replace obsolete instruments and acquire the more advanced equipment which technology has produced. Right now IMR has more than 40 pieces of scientific apparatus and research support equipment on its "needs list". The items range from $400 Xenon lamps for lighting the stages of high-powered microscopes to $80,000 Coulter Counters which enable a technician to count and analyze the number of cells present in a tissue sample or culture. We also have an acute need for computer capabilities to facilitate the work of our scientists and business management functions, particularly with respect to our grants and contracts with the National Institute of Health. (A current "laboratory instruments and Support Services equipment" list is attached in Appendix I.)

CONCLUSION

Mr. Chairman and members of the Committee, I urge you to endorse and seek passage of H.R. 4667. The provisions found in this Amendment to the Internal Revenue Code of 1954 will give tax-exempt independent research organizations an opportunity and incentive to seek out corporate donors of much needed basic research and support equipment. In this regard, we will be authorized to present ourselves as equals to and partners of universities and colleges which share responsiblity for the conduct of the nation's biomedical research and development activity.

Thank you for your consideration of my request for positive action on H.R. 4667.

APPENDIX I.—*Institute for medical research; research equipment needs*

1	Coulter counter	$80,000
1	Protein sequencer/amino acid analyzer	60,000
1	Micro Flow fluorimeter	40,000
1	Zeiss research photomicroscope	32,000
2	High performance liquid chromatographs at $15,000	30,000
2	Liquid nitrogen refrigerators at $12,000	24,000
1	Scintillation counter	22,000
1	Spectrophotometer	18,000
1	Corning gel electrophoresis apparatus	15,000

1 DNA synthesizer	15,000
1 Gas chromatograph	12,000
1 Orthomat microscope	12,000
1 Sorvall RC5B centrifuge	10,600
1 Liquid nitrogen fail-safe refrigerator	10,000
1 Sorvall RC2B centrifuge	6,000
1 New Brunswick plate starter	5,200
1 Fluorescent spectrometer	5,000
1 High voltage power supply and chamber	5,000
1 Spinco 50.1 centrifuge rotor	4,720
1 Mettle balance	4,500
2 Fraction collectors, table top, at $2,000	4,000
1 Spinco SW25.1 centrifuge rotor	3,940
1 Deep freeze	3,500
2 TV cameras and receivers at $1,750	3,500
2 Inverted microscopes at $1,500	3,000
1 Ampule sealer	3,000
Cytocentrifuge	2,500
Oil objectives lenses	2,500
High power objectives lenses	2,000
1 Binocular microscope	2,000
1 Electrophoresis system	1,200
1 Micro centrifuge	1,100
1 Microscope phase condenser	1,100
1 Micro-photo camera	1,100
1 Speed Vac	1,000
Micro-photo accessories	1,000
Narrow band filters	1,000
Condensers with lenses	1,000
1 Conductimeter	850
1 Large slab gel drier	700
1 Kodak dust and static remover	600
1 Labline Imperial III waterbath, 2 temp (60°C; 37°C)	550
High intensity Xenon lamps	400
Computer hardware and software capabilities to use in scientific research and business functions.	

Mr. MATSUI. Thank you.
Mr. Pharo.

STATEMENT OF RICHARD PHARO, DIRECTOR OF RESEARCH ADMINISTRATION, EYE RESEARCH INSTITUTE OF THE RETINA FOUNDATION

Mr. PHARO. Congressman Matsui, Mr. Chairman, I am Richard Pharo, I am currently director of research administration at the Eye Research Institute in Boston, Mass. I am also past president of the Association of Independent Research Institutes and currently the president of the fund for the advancement of biomedical research in this country.

I am here to speak today in behalf of H.R. 4667, which will bring into conformity, we hope, the situation concerning contribution of scientific equipment for research purposes.

I commend this committee for its actions that it took last year in encouraging in this very important way the greater involvement by the private sector in an activity, that is research, which has been traditionally, financially at least, the responsibility of the Federal Government.

Largely through an oversight, I believe, a significant element of nonprofit research capacity of our country was omitted from the legislation last year. That element of the research capacity is the several hundred independent nonprofit research institutions whose activities account for one-quarter or more of the research output of the nonprofit sector.

An independent research institution is defined as an institution established to pursue research and having no formal affiliation with the college or universities.

H.R. 4667 addresses the matter of these institutions and seeks to provide them with parity to their counterparts in the academic community with respect to this matter of the donation of scientific equipment for research purposes.

An independent nonprofit research institution serves as a center where scientists who have no particular interest in teaching, faculty matters, education committees, or other trappings of academia, can come to apply their skills totally toward research.

We believe such a total commitment to research in the absence of the disadvantages of other activities allows for greater concentration of research skills and thus greater output of research results.

For those whose interests are strongly in research, the independent research institute offers an environment where those interests can be maximally utilized. I shall not take the time to recite the entire litany of the research contributions which have arisen from this sector of science. But a few brief examples, however, in the field of biomedical research alone, I think, will orient you to the kinds of organizations about which I am speaking of.

The Papanicolaou Cancer Research Institute in Miami has given us the famous Pap smear test, that well-known method of detecting cervical cancer. From the Worchester Foundation for Experimental Biology in Worchester, Mass., has come the knowledge of the birth control pill, today a widely used method for family planning.

The Jackson Laboratory in Bar Harbor, Maine has developed hundreds of strains of very special laboratory mice which are used by the millions throughout the world in advancement in cancer, in immunology, nutrition, metabolic problems, and many other vital areas of medicine.

The work at my own Eye Research Institute in Boston on the problem of laser photocoagulation has made possible the treatment of thousands of people threatened with loss of vision from diabetes.

I think you can see from these very few examples that these institutions make significant contributions to the improvement of man's state.

These kinds of institutions, all 501(c)(3) or related tax exempt organizations rely on the same sources of funding as do colleges and universities. Because available funding provides only a fixed, limited pool of support, which cannot possibly meet all of the total aspirations of the combined research community there is a strong competition among the members of that community for the limited funds.

Traditionally efforts for competition among the research community have been based on the same guidelines, rules, opportunities, and mechanisms for the academic and independent research institutions. However, as a result of the Internal Revenue Code amendment enacted last year a bias has been introduced into this system which tends to unbalance the opportunities available to the academic compared to the independent research institutions.

A business considering donating a piece of scientific equipment to a nonprofit organization must consider not only the merits of the proposed research projects, but also at which institution that business might realize the greater tax advantage.

Both types of institutions are recognized as tax-exempt charitable activities under the general law. Both serve a valuable function in conducting research for the improvement of mankind. Both offer opportunities for participation by all sectors in the support of that research. Both should be afforded the same access to that support through equal application of the law.

In summary, on behalf of the independent nonprofit research institutions of this country, I urge this committee to favorably report out H.R. 4667. These institutions fill a vital role in the research structure of our country, providing places where scientists who are willing to commit their entire career efforts to research can do so and not have to consider teaching and other academic activities.

Some of the research output of these independent institutions is well known to the public and has brought about significant advantages to the health and well being of our country. This bill will rule equal provisions under the law to independent nonprofit research institutions so they can continue to compete equally with the academic community for available support of their research efforts.

Thank you for your kind attention to this request, and I will be glad to answer any questions I can on the matter.

Chairman **Stark**. Thank you very much for your testimony. Your complete statement will be part of the record.

The other members may have other questions. We appreciate you responding.

[The prepared statement follows:]

STATEMENT OF RICHARD L. PHARO, SC. D., DIRECTOR OF RESEARCH ADMINISTRATION, EYE RESEARCH INSTITUTE, BOSTON, MASS.

Mr. Chairman, and honorable members of the House Ways and Means Committee, my name is Richard L. Pharo. I am Director of Research Administration at the Eye Research Institute in Boston, Massachusetts. I have come today to speak briefly on behalf of House Bill 4667, which seeks to amend the Internal Revenue Code of 1954 to include certain tax-exempt organizations as eligible recipients of scientific property for purposes of the special consideration of the charitable contribution deduction for such property.

Last year this Committee considered and reported favorably a bill amending the Internal Revenue Code of 1954 which would make it possible for a business to contribute appropriate pieces of scientific equipment to colleges and universities for research purposes, and for which that business could calculate a favorable deduction on its income tax return. This was a significant step forward over the prior existing legislation on the matter, because it allowed a greater tax benefit than before to business and, therefore, provided valuable additional incentive for businesses to become more involved in and supportive of the efforts of our academic research system. The advantages to our Country of this step forward are many and were discussed before this Committee at great length. I commend this Committee for its insight into the matter. You encouraged in this way a greater involvement by the private sector in an activity—research—which has been traditionally at least largely the financial responsibility of the Federal government. I see reflected in this action the new orientation of government involvement in the private sector.

Largely through an oversight, I believe, a significant element of the non-profit research capacity of our Country was omitted from the legislation last year. That element of the research capacity is the several hundred independent, non-profit research institutions whose activities account for one-quarter or more of the research output of the non-profit sector. An independent research institution is defined as an institution established to pursue research and having no formal affiliation with a college or university. Its non-profit status is determined by its structure and purpose, and is defined by appropriate Internal Revenue Code regulations. H.R. 4667 addresses the matter of these institutions and seeks to provide them with parity to their counterparts in the academic community with respect to this matter of donation of scientific equipment.

The kind of organization addressed in this proposed bill is represented by my own institution, the Eye Research Institute in Boston. Within the field of biomedical research, I am familiar with many institutions of this type, having served as President of the Association of Independent Research Institutes, comprising over 40 such organizations. Currently as President of the Fund for the Advancement of Basic Biomedical Research, I have a clear overview of the role which the independent non-profit research institution plays in the total effort of biomedical research.

An independent non-profit research institution serves as a center where scientists who have no particular interest in teaching, faculty matters, education committees, and other trappings or academia can come to apply their skills totally toward research. We believe that such total commitment to research, in the absence of the distractions of other academic activities, allows for greater concentration of research skills and, thus, greater output of research results. Such a research environment is not appropriate for all scientists. Many researchers obviously prefer the more diverse career offered in an academic institution. However, for those whose interests are strongly in the research field, the independent research institute offers an environment where those interests can be maximally utilized.

I shall not take the time to recite the entire litany of research contributions which have arisen from this sector of science. A few brief examples, however, I think will orient you to the kinds of organizations about which I am speaking. The Papanicoloau Cancer Research Institute at Miami has given us the famous Paps smear test, that well-know method for detecting cervical cancer. From the Worcester Foundation for Experimental Biology in Worcester, Massachusetts, has come the knowledge of the birth control pill, today a widely-used method for family planning. The Jackson Laboratory in Bar Harbor, Maine, has developed hundreds of strains of special laboratory mice which are used by the millions in research and testing centers throughout the world in advancements in cancer, genetics, immunology, nutrition, metabolic problems, and other vital areas of medicine. The work at my own Eye Research Institute on laser phtocoagulation has made possible the treatment of thouands of people threatened with loss of vision from diabetes. I think you can see from these few examples that these institutions make significant contributions to the improvement in man's state.

These kinds of institutions, all 501(c)(3) or related tax-exempt organizations, rely on the same sources of support as do colleges and universities. Certainly, funds from the Federal government are a major source. In addition, the private sector, although generally of lesser magnitude, plays an important role in funding for these research institutions. Because these two areas of funding provide only a fixed, limited pool of support, which cannot possibly meet all the total aspirations of the combined research community, there is strong competition among the members of that community for those limited funds.

This competition is desirable and important, because it helps to insure that only the best research will be pursued; that only the most meritorious ideas will be supported. Traditionally the efforts for competition among the research community for support have been based on the same guidelines, rules, opportunities, and mechanisms for both the academic and independent research institutions. In most cases research projects are reviewed for scientific merit, often by a committee of peers, and funds awarded based on that merit. Especially in the private sector, a decision may be weighted to endorse an academic institution because of its "stability" or "traditionalness", or to an independent institution because of its "pioneering spirit." Such determinations based on philosophical outlook help maintain the diverse, heterogeneous distribution of efforts which make our Country strong in so many areas.

However, as a result of the Internal Revenue Code amendment enacted last year, a bias has been introduced into this system which tends to unbalance the opportunities available to the academic compared to the independent research institutions. A business consideration donating a piece of scientific equipment to a non-profit institution must now consider not only the merit of the proposed research projects, but also at which institution that business might realize the greater tax advantage. Clearly in our profit-oriented economy, the business is most likely to make the donation where it will realize the larger tax advantage. By the omission of the independent non-profit research institution from the tax code amendment last year, a disproportionate edge was given to academic institutions in this matter.

Both types of institutions are recognized as tax-exempt, charitable activities under the general law. Both serve a valuable function in conducting research for the improvement of mankind. Both offer opportunities for participation by all sectors in the support of that research. Both should be afforded the same access to that support through equal application of the law.

If H.R. 4667 is enacted, will it change significantly the total involvement of business in non-profit research efforts? Quite frankly, in my own opinion I do not think so. I believe business will continue to make the same level of equipment donations that it would have without the amendment. However, it will allow the independent research institution to compete once again on the basis of scientific merit for that fixed amount of available equipment, with equal protection provided by the law for the financial considerations involved in this kind of donation.

In summary, on behalf of the independent non-profit research institutions of this country, I urge this Committee to favorably report out H.R. 4667. These institutions fill a vital role in the research structure of our Country, providing places where scientists who are willing to commit their entire career efforts to research can do so and not have to consider teaching and other academic activities. Some of the research output of these independent institutions is well known to the public and has brought about significant advances in our health and well-being.

This bill will restore equal provisions under the law to independent non-profit research institutions so they can continue to compete equally with the academic community for available support of their research efforts. A business need once again consider only the scientific merit of proposed research projects they may support, and not have to consider the financial advantages of donating to one non-profit or another non-profit institution.

Thank you, Mr. Chairman and Honorable Members of the House Ways and Means Committee, for your time and attention to this matter. I shall be glad to try to answer any questions you may have on this subject.

Chairman Stark. Excuse me, I would like at this time to call out of order the Honorable Hank Brown, a Member of Congress from the State of Colorado, for his testimony on H.R. 5177.

Without objection, your prepared statement will be made part of the record and you may summarize or make any additional remarks that you care to submit.

Welcome to the committee.

STATEMENT OF HON. HANK BROWN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF COLORADO

Mr. Brown. Mr. Chairman, thank you. I appreciate the chance to appear before you.

I just have a personal note in addition to my remarks. Many individuals affected by the taking of about a quarter of a million acres of ranchland in Colorado face a real hardship, in that the lands belonged to their families for several generations. It is difficult for them to find other land in which they can move on to.

This proposed legislation is a simple mechanism that allows them to be assured that their exchange is treated as an involuntary exchange by the tax code. I do not think it is controversial, but it is a great deal of help to the individuals who have been called upon to make a unique sacrifice for their country.

Chairman Stark. Thank you very much.

[The prepared statement follows:]

Statement of Hon. Hank Brown, a Representative in Congress From the State of Colorado

Mr. Chairman, I appreciate the opportunity to appear before the Subcommittee to address the taxation aspect of the Ft. Carson land acquisition.

Federal acquisition of land in Las Animas County, Colorado will deprive many of property that has been in their family for generations. This is primarily agricultural land used for livestock grazing.

Many of the landowners would prefer to exchange their land for other federally-owned parcels in Colorado. However, Congress did not include specific language in the conference report of the Military Construction Appropriation bill directing the Army to identify comparable federal land for exchange. As the Army may not comply with this suggestion in the report, the only alternative would be for us to compensate these landowners for their economic loss.

Locating comparable land for the ranchers is extremely difficult. The expenses for the search easily exceed the $500 limit placed on relocation research benefits. The citizens have been asked to make a significant sacrifice for their country, and I know the Committee shares my concern that we treat them fairly. The legislation currently under consideration, H.R. 5177, would permit persons who surrender these lands to the Ft. Carson military installation to treat the conveyance of such lands as involuntary conversions for the purposes of section 1033 of the Internal Revenue Code. While each of them would technically qualify for section 1033, the passage of this bill would legally recognize that the land was, in fact, involuntarily surrendered, and relieve the landowners of having to justify their applications.

Mr. MATSUI. Mr. Chairman. May I just submit for the record a statement of Neal W. Powell, which would have been presented by Richard B. Stanger of a Washington law firm regarding this particular issue.

Chairman STARK. Without objection, it will be made part of the record.

[The statement follows:]

STATEMENT OF NEAL W. POWELL, TOWN ADMINISTRATOR, TANEYTOWN, MD.

My name is Neal W. Powell, and I am Town Administrator of Taneytown, Maryland. Since 1972, we have maintained a money purchase pension plan containing a cash or deferred arrangement as a retirement savings vehicle for Town employees. Because of our strong belief that this plan should be permitted to continue benefiting our employees, I am here today to testify in favor of H.R. 4948.

Our plan was established in good faith during the middle of 1972 based on a series of pre-ERISA Revenue Rulings promulgated by the Internal Revenue Service. Since the date of its establishment, our plan has consistently met the non-discrimination requirements mandated under the Internal Revenue Code and continues to cover a broad cross-section of our admittedly small employee population. Of the eight employees who are currently eligible to participate, five are actively participating in the plan, including a secretary, a member of a road crew, a police officer, and a maintenance worker.

We selected this particular type of plan for several reasons. First, the availability of a cash or deferred arrangement as a plan funding method enabled the Town to establish and initially maintain the plan without the sort of ongoing financial obligation normally associated with the establishment of a traditional qualified retirement plan. But for this factor, it is likely that the plan would never have been established in the first place. Second, the election to forego current compensation as a means of contributing to the funding of one's retirement benefit represents an important step in recognizing our individual responsibility to effect some means of saving for our own retirement years. Third, by matching employee contributions under a cash or deferred arrangement on a dollar-for-dollar basis, the Town has managed to build up substantial amounts of plan assets for the benefit of plan participants. Upon distribution, these funds will provide a meaningful retirement benefit for our employees. Finally, and perhaps most importantly, the ability of employees to make contributions on a before-tax basis serves as a substantial inducement to full plan participation. Many of our employees could not afford the cost of the contributions on an after-tax basis.

We believe that our Town and other small employers should be permitted to continue existing money purchase pension plans with cash or deferred arrangements which satisfy all pertinent statutory and regulatory requirements so that all affected employees may continue to have this valuable and effective retirement savings vehicle available to them. We fear that the failure of Congress to act favorably on this Bill will result in the unwarranted termination of hundreds of these plans by similarly situated plan sponsors—municipalities that cannot set up cash or deferred, profit-sharing or stock bonus plans—with the most unfortunate results for thousands of plan participants. For all of these reasons and because of our understanding that the Internal Revenue Service has already proposed regulations which would destroy the viability of money purchase pension plans containing cash or deferred arrangements, we urge that this Committee favorably report H.R. 4948 as soon as possible.

Chairman **Stark**. Now we will call Mr. John Nolan, representing Hand & Associates, and the Third Farm Credit District of Columbia, S.C.

We have, I believe, your prepared testimony. You may summarize it.

STATEMENT OF JOHN S. NOLAN, COUNSEL, HAND & ASSOCIATES OF HOUSTON, TEX., AND THIRD FARM CREDIT DISTRICT, COLUMBIA, S.C.

Mr. **Nolan**. I am a member of the law firm of Miller & Chevalier, Chartered. I am here today to speak in favor of H.R. 4948—an important bill which would permit certain money purchase pension plans to qualify as cash or deferred arrangements under Section 401(k) of the Internal Revenue Code and, in so doing, correct a clear oversight in the tax laws.

The two clients on whose behalf I speak are Hand & Associates of Houston, Tex., and the Third Farm Credit District of Columbia, S.C.

Hand & Associates is an employee benefits consulting firm which renders professional services to hundreds of pension and profit sharing plans all over the country. Many of the plans which Hand serves are money purchase pension plans maintained by employers located principally in the South and Southwest. These employers are, for the most part, small businesses employing less than 20 employees.

The Third Farm Credit District, one of Hand & Associates' largest clients, maintains a money purchase pension plan known as the Farm Credit Employee Thrift Plan-Columbia District. That plan includes employees of the Federal Land Bank, Federal Intermediate Credit Bank, Columbia Bank for Cooperatives and, in addition, has been adopted by scores of Federal land bank associations and production credit associations in the Farm Credit System's Third District (which includes North Carolina, South Carolina, Georgia, and Florida.)

Many of the organizations in the Farm Credit System are tax-exempt organizations under section 501(c)(1) of the code. The Third District's money purchase pension plan covers approximately 1,500 employees.

For years, money purchase pension plans have been attractive to tax-exempt organizations and small businesses which, for various reasons, could not adopt profit sharing or stock bonus plans and were unable to assume the substantial commitment necessitated by a defined benefit pension plan.

H.R. 4948 relates to money purchase pension plans funded, in whole or in part, by salary reduction contributions. A salary reduction contribution is a contribution made by an employer to a benefit plan pursuant to an agreement under which an employee elects to have his future salary reduced with the understanding that the reduced amount will be contributed by the employer to the benefit plan.

H.R. 4948 would correct an unfortunate oversight which occurred when the Revenue Act of 1978 added section 401(k) to the Internal Revenue Code. Under section 401(k), an employee may elect to have a portion of his compensation contributed to a profit sharing or stock bonus plan, and the amount so contributed would not be considered as included in his gross income.

The Internal Revenue Service has indicated in proposed regulations that contributions to section 401(k) plans may be made pursuant to salary reduction agreements. Because a money purchase pension plan is neither a profit sharing plan or a stock bonus plan, it cannot qualify as a section 401(k) plan. If H.R. 4948 is not enacted, the Service will tax an employee's salary reduction contributions to a money purchase plan and thereby treat such contributions differently from similar contributions made to profit sharing and stock bonus plans which now qualify under section 401(k).

To make matters worse, the Service's income inclusion rule would apply retroactively to all salary reduction contributions made to money purchase pension plans after December 31, 1979.

H.R. 4948 would correct this unfair result by allowing certain qualified money purchase plans to enjoy the same protections and tax advantages which are afforded the profit sharing and stock bonus plans under section 401(k). The bill would amend section 401(k) to provide that a salary reduction money purchase pension plan may qualify as a cash or deferred arrangement under section 401(k) if:

One, the plan was in existence on June 27, 1974—which is the date specified in the grandfather rule in section 2006 of ERISA); and two, the plan has not, since that date, increased the level of employer or employee contributions provided for under the plan contribution formula.

H.R. 4948 would also amend code section 402(a)(8) to provide protection from the constructive receipt doctrine to a money purchase plan which meets the foregoing new requirements in section 401(k).

The subcommittee should be aware that Senator Wallop, in October 1981, introduced S. 1794, a bill which, except for the effective date provision, is identical to H.R. 4948 introduced by Mr. Matsui. These two bills—H.R. 4948 and S. 1794—include the same substantive provisions as those which appeared in H.R. 5391, a bill which was adopted by the Senate in December 1980.

In conference, the House conferees chose not to approve the money purchase plan provisions of H.R. 5391 for the sole reason that the House had not held hearings on them prior to their consideration by the Senate. Significantly, Treasury did not oppose the provision of H.R. 5391 which related to money purchase pension plan.

I was delighted when the Treasury approved this bill and in fact suggested that it might go further. There is no reason to treat salary reduction money purchase plans different from other plans which may not qualify as cash or deferred arrangements under section 401(k). On behalf of Hand & Associates, and the more than 1,500 employees participating in the Farm Credit plan for the Third District, I strongly urge you to report H.R. 4948 favorably.

[The prepared statement follows:]

STATEMENT OF JOHN S. NOLAN, MILLER & CHEVALIER, CHARTERED, ON BEHALF OF HAND & ASSOCIATES, AND THE THIRD FARM CREDIT DISTRICT

I am John S. Nolan, member of the law firm of Miller & Chevalier, Chartered. I am here today to speaker in favor of H.R. 4948—an important bill which would permit certain money purchase pension plans to qualify as cash or deferred arrangements under §401(k) of the Internal Revenue Code and, in so doing, correct a clear oversight in the tax laws. The two clients on whose behalf I speak are Hand and Associates of Houston, Texas and the Third Farm Credit District of Columbia, South Carolina.

Hand and Associates is an employee benefits consulting firm which renders professional services to hundreds of pension and profit sharing plans all over the country. Many of the plans which Hand serves are money purchase pension plans maintained by employers located principally in the South and Southwest. These employers are, for the most part, small businesses employing less than 20 employees. Collectively, these plans cover almost 3500 employees.

The Third Farm Credit District, one of Hand and Associates' largest clients, maintains a money purchase pension plan known as the Farm Credit Employee Thrift Plan—Columbia District. That plan includes employees of the Federal Land Bank, Federal Intermediate Credit Bank, Columbia Bank for Cooperatives and, in addition, has been adopted by scores of federal land bank associations and production credit associations in the Farm Credit System's Third District (which includes North Carolina, South Carolina, Georgia and Florida). Many of the organizations in the Farm Credit System are tax-exempt organizations under § 501(c)(1) of the Code. The Third District's money purchase pension plan covers approximately 1500 employees.

Money purchase pension plans have for years been attractive to tax-exempt organizations and small businesses which, for various reasons, could not adopt profit sharing or stock bonus plans and were unable to assume the substantial commitment necessitated by a defined benefit pension plan. A money purchase pension plan allows the employer to fund an employee's pension by making fixed contributions (usually based upon a specified percentage of the employee's compensation) to an account established for the employee under the plan. The name "money purchase" has been affixed to these plans because the pension benefit is determined by the annuity which the money available in the employee's account would purchase at retirement.

H.R. 4948 relates to money purchase pension plans funded, in whole or in part, by "salary reduction" contributions. The Third District's money purchase pension plan operates on a salary reduction basis and its provisions are typical of most salary reduction money purchase plans. Under the Third District's plan, and employee is required to contribute six percent of his annual compensation in order to participate in the plan. The employee's contribution is made in accordance with a salary reduction agreement which the employee voluntarily executes prior to the year in which the compensation is to be paid. The agreement is irrevocable for the entire year and may be renewed in subsequent years at the employee's option. The employer supplements the employee's salary reduction contribution with a matching contribution of three percent of the employee's compensation. In our experience, we have found a fifty percent employer contribution to be fairly common, but in many cases, employers match the salary reduction contributions at a 100 percent level.

Under the Third District's plan, the employee is always fully vested in his salary reduction contributions. Vesting in the employer matching contributions occurs at the rate of twenty percent per year. Inasmuch as the Third District's plan, like all money purchase pension plans, is qualified as a "pension plan" under Code section 401(a), participating employees are denied the right to make inservice withdrawals from their respective account balances. Rather, their account balances are available only upon separation from service, disability or death.

H.R. 4948 would correct an unfortunate oversight which occurred when the Revenue Act of 1978 (Public Law 95-600) was enacted. That Act added § 401(k) to the Internal Revenue Code. Section 401(k) permits cash or deferred arrangements to qualify under § 401(a) and to operate without concern for the constructive receipt doctrine. The 1978 Act made cash or deferred arrangements available only with respect to profit sharing plans and stock bonus plans, however. Pension plans, which are a distinct generic category under § 401(a), were not mentioned in the legislation, with the result that a salary reduction money purchase plan may not now qualify as a cash or deferred arrangement under § 401(k).

We submit that Congress always intended to cover salary reduction money purchase plans in specific legislation. Section 2006 of ERISA precluded Treasury from issuing final regulations with respect to such plans prior to a deadline date specified in the statute. Although Congress believed that it set the deadline far enough into the future to give it adequate time to study the matter, it was compelled to extend the deadline twice thereafter. The Revenue Act of 1978 was enacted before the expiration of the last deadline, and, without explanation, that Act did not extend the § 401(k) rules to salary reduction money purchase pension plans.

Under § 401(k), an employee may elect to have a portion of his compensation contributed to a profit sharing or stock bonus plan, and the amount so contributed would not be considered as included in his gross income. The Internal Revenue Service has indicated in proposed regulations that such contributions may be made pursuant to salary reduction agreements. If H.R. 4948 is not enacted, the Internal Revenue Service will tax an employee's salary reduction contributions to a money purchase plan and thereby treat such contributions differently from similar contributions made to cash or deferred arrangements under § 401(k). In proposed regulations issued in November 10, 1981 (46 Fed. Reg. 55544), the Service announced that contributions made to any plan, under an arrangement whereby the employee has the option to take an amount in cash or contribute it to a plan, will be taxable as gross income if the plan does not qualify under § 401(k). Inasmuch as a money purchase pension plan cannot qualify under § 401(k), the proposed rule of the Service would result in taxable income to all employees who participate in salary reduction money purchase plans. This would be an unsound and unfair result. To make matters worse, the Service's income inclusion rule would apply retroactively to all contributions made after December 31, 1979.

H.R. 4948 would correct this unfortunate result by allowing certain qualified money purchase plans to enjoy the same protections and tax advantages afforded to profit sharing and stock bonus plans under § 401(k). The Bill would amend § 401(k) to provide that a salary reduction money purchase pension plan may qualify as a cash or deferred arrangement under § 401(k) if: (1) the plan was in existence on June 27, 1974 (which is the date specified in the "grandfather rule" in § 2006 of ERISA); and (2) the plan has not, since that date, increased the level of employer or employee contributions provided for under the plan contribution formula. H.R. 4948 would also amend Code § 402(a)(8) to provide protection from the constructive receipt doctrine to a money purchase plan which meets the foregoing new requirements in § 401(k).

The Subcommittee is no doubt aware of the fact that Senator Wallop, in October 1981, introduced S. 1794, a bill which is identical to H.R. 4948 introduced by Mr. Matsui. These two bills—H.R. 4948 and S. 1794—include the same provisions as those which appeared in H.R. 5391, a bill which was adopted by the Senate in December 1980. In conference, the House conferees chose not to approve the money purchase plan provisions of H.R. 5391 for the sole reason that the House had not held hearings on them prior to their consideration by the Senate (Cong. Rec. H. 12469, December 13, 1980, remarks of Mr. Conable and Mr. Ullman). Treasury did not oppose the provision in H.R. 5391 which related to money purchase pension plans.

There is no reason to treat salary reduction money purchase plans different from other plans which qualify now as cash or deferred arrangements under § 401(k). Congress expressed its desire in ERISA, and more recently, in H.R. 5391, to grant certain money purchase plans the same treatment as that currently available to profit sharing and stock bonus plans. On behalf of Hand and Associates, and the more than 1500 employees participating in the Farm Credit Plan for the Third District, I strongly urge you to report H.R. 4948 favorably.

Chairman STARK. It has been a long day for you, has it not?

Mr. NOLAN. I am pleased to be here this afternoon.

Chairman STARK. Mr. Matsui?

Mr. MATSUI. Thank you, Mr. Chairman. I do not really have any questions for Mr. Nolan. I would just like to further point out that in addition to affecting small businesses, of which Mr. Nolan represents, you mentioned two of them, the other gentleman that was going to testify, Mr. Stanger, would have testified to the fact that some small governmental entities that are nonprofit would also be affected by the Treasury recommendation.

Perhaps I do have some questions. Is there some emergency to this legislation?

Mr. NOLAN. Yes, because the IRS is really holding off on their regulation to see what is done with respect to this bill. It is a very important bill. I have lived with this issue ever since it first arose in 1972. Money purchase pension plans, using the salary reduction concept, are the way to get new plans adopted by small businesses. That is the way to persuade a small business to adopt a new plan. The small businessman is able in effect to share in additional incremental cost of the plan with the employees by the salary reduction method. Thus, it is a very important bill in that it could extend the coverage of the private pension system. It is important that the Treasury Department is coming down in favor of this bill.

Mr. MATSUI. Thank you.

Chairman STARK. Thank you very much.

That brings us to Mr. Patrick J. Hindert, president of Benefit Designs, Inc., and Mr. David M. Higgins, from Overton, Lyman & Prince. The last, but not least for the day. They are accompanied by a good friend and former colleague, Mr. James Corman. I am sure the gentlemen will now proceed to destroy the testimony of the Secretary of the Treasury. You may proceed to do that in any manner you see fit.

STATEMENT OF PATRICK J. HINDERT, PRESIDENT, BENEFIT DESIGNS, INC.

Mr. HINDERT. I am president of Benefit Designs, Inc., a consulting firm located in Cincinatti, Ohio, that specializes in the negotiation and financing of catastrophic personal injury cases using periodic payments. I am going to defer to Mr. Higgins to destroy the arguments of the Treasury Department.

Instead, what I would like to do in the time allotted to me in addressing H.R. 5470 are three things. First, for clarification, define what periodic payments are in the context of personal injury cases. Second, I would like to offer three public policy arguments in favor of both periodic payments and the specific bill as it is written right now. And third, I would like to discuss on a broader basis the implications from a societal perspective of what we are facing in the personal injury area.

Periodic payments, first of all, can be defined as predefined benefits over time, either in place of or in addition to a single lump sum. It is important to differentiate periodic payments from one of the things that the Treasury Department was talking about this morning. That is a lump sum that is either actually or constructively received, whereby the investment income is going to be paid to the claimant.

We are not talking about that for periodic payments. We are talking about predefined benefits. Now that could mean something as simple as the following example. Let's assume that a jury awards a claimant $10,000 in future medicals, payable immediately in a lump sum. As an alternative to that lump sum, periodic payments could involve predefined payments for a set period of years, $1,000 per year for 10 years, if the claimant's life expectancy was 10 years, or it could involve $1,000 for the lifetime, or it could involve $1,000 a year for the lifetime of the claimant increasing by a set percentage, 5 percent a year, or it could involve $1,000 a year increasing by an index, a cost-of-living index. Or it could involve an agreement by the defendant to pay all future medical expenses of the claimant, whatever they are. All of those are examples of predefined benefits, where a claimant is going to receive a predefined amount per month or per year from the defendant.

There are three public policy arguments in favor of periodic payments, as opposed to a lump sum. The first argument would be the periodic payments to provide more accurate compensation. If you take the example of the claimant that has future medicals for the remainder of their lifetime and you look at a $10,000 verdict, for example, that is a lump sum, if the claimant were to die the next month, clearly there is overpayment of the medical.

On the other hand, if the claimant lives far beyond his life expectancy but the medicals continue, there has been an underpayment. Periodic payments allows in a situation that occurs over and over again, payments for needs that exist as long as a specific claimant remains alive. Therefore, the compensation or the benefits received are more accurate than a lump sum. That is the first public policy argument in favor of periodic payments.

Chairman STARK. Is it correct that a court cannot award an unspecified amount in a lawsuit?

Mr. HINDERT. Typically, because of the common law single recovery room, courts are not allowed to hand down verdicts that are anything but a lump sum. There are only a few enabling statutes, the workers compensation statutes, the no-fault statutes and in a few States——

Chairman STARK. Unless this is negotiated?

Mr. HINDERT. Unless it is a settlement.

Chairman STARK. Which is part of the reason for doing it. The courts cannot do it. It has to be done subject to negotiated settlement?

Mr. HINDERT. That is correct.

The second argument is that periodic payments provide a better allocation of risk. What has happened unfortunately with claimants is regardless of how much money they have received, they have done a very poor job of managing that money for the future needs and consequently are frequently back on the public dole to pay for their payments.

It makes more sense for financial institutions to take on the allocation of the investment mortality risk to be able to pay for these future payments.

The third advantage of periodic payments has to do with the financial flexibility that they provide. Both the economy and the problems that the claimants face have become so complex that the lump sum is not a satisfactory means of either negotiating the settlement or of putting a plaintiff in the position that he was before the accident. This is one of the reasons why this particular amendment to section 104(a)(2) is needed, because financial flexiblity reqires more than just the defendant being allowed to pay future payments over time.

That defendant could be a doctor, a manufacturing company, it could be any number of people or entities that are not well equipped to meet the complex needs of a claimant over a period of time. What this bill would encourage would be to take the financial resources, the financial companies that are in existence currently in the United States and encourage them to apply their creativity and their resources to solving a very complex, important social need. That is, the payment of these large sums of money to claimants over time.

The problem that we are really trying to resolve is on the one hand verdicts that are so high it is putting companies out of business. That evidence is as recent as this morning's Wall Street Journal in talking about the asbestos cases. The other problem is that regardless of how much money these claimaints are receiving, they are not able to properly manage it for their needs and therefore, are having to come back to the Government, to the pubic to pay for those needs.

I think periodic payments in general and this specific bill in particular, will spotlight the problem and encourage a creative useful approach to an important societal problem.

That completes my testimony

Chairman STARK. Thank you very much.

[The prepared statement follows:]

STATEMENT OF PATRICK J. HINDERT, PRESIDENT, BENEFIT DESIGNS, INC.

1. CURRENT TAX LAW

In I.R.C. Section 104 (a)(2), Congress has previously provided a tax preference for "damages received" by an injured party in personal injury cases. Historically, it was assumed that "damages received" included only the payment of a single, immediate lump sum. Personal injury awards or settlements, however, frequently compensate an injured party for future damages including medical expenses, lost income and pain and suffering. It is more efficient and appropriate to pay such damages over time as they accrue.

2. DEFINITION OF PERIODIC PAYMENTS

a. Predetermined Benefits.—Periodic payments can be defined as predetermined benefits paid over time in addition to, or in place of, a single immediate lump sum. As predetermined benefits, periodic payments must be distinguished from a settlement that pays an injured party "whatever income is generated from the investment of a certain sum of money". The income from this latter settlement is taxable to the injured party.

b. Example.—As an example of periodic payments, assume an injured party is expected to incur $10,000 of future medicals per year for each of the 10 years he is expected to remain alive. Any of the following periodic payment programs might be an appropriate alternative to a $100,000 ($10,000 × 10 years) lump sum award or settlement:

1. $10,000 per year for 10 years, or
2. $10,000 per year for life, or
3. $10,000 per year for life increasing ten (10%) per year for life, or

4. $10,000 per year for life increasing or decreasing annually based upon changes in the consumer price index, or

5. All reasonable medical expenses paid annually for life.

Based upon existing case law and administrative rulings, each of the above periodic payment options would constitute "damages received" for purposes of I.R.C. Section 104 (a)(2) assuming it was self-financed by the original tortfeasor.

3. ADVANTAGES OF PERIODIC PAYMENTS—PUBLIC POLICY PERSPECTIVE

Contrasted with the $100,000 lump sum, the periodic payment alternatives provide the following advantages from a public policy perspective:

a. *More Accurate Compensation.*—Personal injury damages are intended to restore an injured party to his pre-accident economic status. The $100,000 lump sum intended for future medicals probably will not accomplish this objective. If the injured party dies prior to his ten (10) year life expectancy, he will not incur $100,000 of medical expenses and his estate will receive a windfall. If he outlives his ten (10) year life expectancy, his medical expenses will continue and he could suffer a shortfall even assuming the $100,000 is wisely invested. Periodic payments can offer a conceptual improvement to this problem of inaccurate compensation by providing annual medical payments so long as the injured party remains alive.

b. *Improved Risk Allocation.*—An injured party who receives a lump sum is frequently ill-equipped psychologically, physically or educationally to assume the investment and mortality risks associated with managing money to satisfy anticipated future financial requirements. Original tortfeasors, their insurers, or assignees, are likely to be better suited to assuming such risks pursuant to a periodic payment program.

c. *Financial Flexibility.*—Many aspects of personal injury litigation have increased substantially in complexity in recent years, including theories of liability, the general economic climate, available medical and rehabilitative facilities, etc. A single lump sum provides very little flexibility for resolving such complexities. Periodic payments, on the other hand, offer tremendous flexibility for addressing the problems of an injured party upon the most cost effective basis possible.

4. NECESSITY OF H.R. 5470

H.R. 5470 represents a necessary amendment to the Internal Revenue Code and should be adopted for the following reasons:

a. H.R. 5470 would codify existing case law and administrative law and provide assurance concerning tax treatment to parties entering into periodic payments. In the absence of H.R. 5470, such parties must rely upon private letter rulings which require considerable advance notice and therefore prohibit many parties from settling on the basis of periodic payments.

b. H.R. 4570 would produce a substantial saving in governmental expenditures by encouraging wider usage of periodic payments. Injured parties who receive lump sum settlements or awards frequently misapply or dissipate such funds and subsequently require public funds to pay for their future medical and maintenance requirements.

c. H.R. 5470 would encourage the creation of increasingly secure and creative programs to finance periodic payments. Under most periodic payment programs currently in force, the party originally liable (defendant or defendant's insurer) promises to make the future payments. The party originally liable (e.g. a doctor), may prove financially incapable of continuing payments for 20, 30 or even 70 years into the future. Likewise, the party originally liable may not have the expertise to design an appropriate financial program for an injured party. By allowing a third party (the assignee) to replace the party originally liable for the periodic payment obligation, H.R. 5470 would invite the most secure, and creative financial institutions in America to develop periodic payment programs for a broad range of personal injury cases.

5. TREASURY CRITICISM OF H.R. 5470

The Treasury Department has put forward the following criticism of H.R. 5470:

a. H.R. 5470 would expand the current law because it permits an assignee to exclude amounts received from the person originally liable regardless of whether the assignee purchases a life insurance annuity with such funds.

Response.—It is true that in existing private letter rulings (LTR 8038044) the assignee purchase a life insurance annuity. There is, however, nothing sacred about annuities. United States Treasury Bonds, for example, are a more secure investment than any annuity. This criticism stresses form over substance.

b. H.R. 5470 does not define what portion of the amounts received by an assignee will be "applied by" the assignee for payment of damages.

Response.—It is my understanding that H.R. 5470, in its current format, has been amended to limit the Section 104(a)(6) exclusion to "that portion of amounts received by an assignee . . . and applied by the assignee to satisfy the obligations assigned." This criticism is now moot.

c. H.R. 5470 would create an overstatement of deductions by permitting an assignee to establish a reserve in much the same fashion as an insurance company.

Response.—The purpose of H.R. 5470 is to permit assignments by placing the assignee in a tax situation identical to the person originally liable for the payment of damages. The exclusion provided under Section 104(a)(6) is not equivalent to an insurance company reserve which creates an immediate tax deduction potentially in excess of recognizable premium income.

d. Under H.R. 5470, an assignee can defer taxation of profit until its obligations are fully satisfied.

Response.—Except when payments continue for the lifetime of the injured party, profits will be based upon the ability of the assignee to achieve investment returns in excess of its periodic payment obligations. Any such excess will be taxed in the year earned. Lifetime payments provide an additional potential for profit or loss. The profit (tax) or loss (deduction) should be recognized only when it becomes fixed and determinable. Any potential for tax deferral by an assignee is further reduced by the proposed amendment to I.R.C. Sect. 1012 which is incorporated into H.R. 5470.

e. H.R. 5470 codifies an existing disparity between the tax treatment applicable to periodic payments and that afforded investment income from lump sums.

Response.—This disparity exists because of the explicit language of Section 104(a)(2) as it currently exists. Once an injured party has received damages (whether lump sum or periodic payments) and invested the proceeds, the income should be taxed to him. To provide otherwise requires Congress to rewrite Section 104(a)(2) rather than merely clarifying its application when an assignment occurs.

H.R. 5470 does not create new tax law. It merely clarifies and codifies existing tax law. But it is necessary to the further, favorable development of periodic payments. When passed, it will reduce the sky-rocketing cost of personal injury awards and settlements and improve the benefits received by injured parties who require substantial assistance.

Chairman STARK. Mr. Higgins?

STATEMENT OF DAVID M. HIGGINS, ESQ., OVERTON, LYMAN & PRINCE

Mr. HIGGINS. Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF DAVID M. HIGGINS, OVERTON, LYMAN & PRINCE

TEXT

The Periodic Payment Settlement Act of 1981 (hereinafter the "Act") clarifies the gross income exclusion set forth in section 104(a) of the Internal Revenue Code of 1954, as amended, (hereinafter the "Code") in those instances when a taxpayer receives compensation for personal injuries as periodic payments and in those instances when a defendant assigns to a third party the liability to make those payments.

1. PURPOSE OF THE ACT—CODIFICATION OF EXISTING LAW

A. Present law

Under present law, the principles set forth in the Act relating to payees of periodic payments are contained in the regulations under Code section 104, in published and private revenue rulings and in long-established judicial opinions. Injured taxpayers have historically received compensation for their personal injuries both as lump-sum payments and as periodic payments spread over the number of years during which their damages accrue. In either form of receipt, the compensation has been free of federal income tax by virtue of the principles contained in Code section

104 for lump sums and in regulations, rulings and decisions for periodic payments. Because the principles relating to periodic payments are not codified, taxpayers receiving such compensation often seek private letter rulings when entering into a settlement of litigation.

Under present law, the principles that apply to payors of periodic payments are contained in published and private revenue rulings. A liability insurer continues to have an open claim file to administer the future payments for their duration and must account annually for those payments in profit-and-loss statements as well as in tax returns. The same is true for a self-insured defendant. To relieve them from those future administrative, accounting and tax burdens, such insurers and self-insured defendants often assign the payment obligation to a third party. The assignee assumes that obligation as well as the administrative, accounting and tax burdens. The plaintiff becomes a general creditor of the assignee and has no further claim against the person originally liable. The defendant and its insurer, upon execution by the plaintiff of appropriate releases, are relieved both from any future payment obligation and from the administrative, accounting and tax burdens.

B. Reasons for change

Obtaining private letter rulings for taxpayers receiving compensation as periodic payments for personal injuries has proven to be a time-consuming and expensive process. Typically from 3 months to a year and substantial legal fees are necessary to obtain such a ruling. In the context of litigation settlement discussions, obtaining a private ruling is therefore impractical. The lack of a ruling results in a degree of uncertainty attached to each settlement. By codifying existing authorities, the Act will eliminate that uncertainly.

Although it is believed that many plaintiffs would be willing to settle pending cases if they were offered periodic payments, defendants and their insurers have been reluctant to offer such payments because of the administrative, accounting and tax burdens. The Act will facilitate settlements in such cases by codifying the principles that apply to an assignee of those burdens.

C. Explanation of provisions

The Act codifies existing administrative and judicial rulings so that the need to obtain private letter rulings will be eliminated with respect to each transaction.

i. Act Section 2(a)—Gross Income Exclusion for Recipients of Periodic Payments.—Act section 2(a) adds a new paragraph to Code section 104(a) to exclude from gross income, periodic payments received as compensation for personal injuries. Code section 104(a)(2), as interpreted by various published and private rulings,[1] excludes from gross income compensation for personal injuries, whether received as a lump sum or as periodic payments, provided the payee is not in constructive receipt of or does not have the current economic benefit of the sum required to produce periodic payments. The first of those ruling was issued in 1977, and later rulings have reaffirmed the exclusion.

ii. Act Sections 2(b) and (c)—Simplification of Defendants' (or Their Insurers') Settlement Administration.—Act section 2(b) amends Code section 104 by codifying that the gross income exclusion is available to plaintiffs receiving periodic payments from an assignee of the defendant or its insurer, provided that the plaintiff's rights against the assignee are no greater than those of a general creditor and that the traditional principles of constructive receipt are not violated. In addition, Act section 2(c), by amending Code section 162, codifies the deductibility by an assignee of such periodic payments.

2. EFFECTS OF THE ACT

Congress should be concerned about the effects of the Act in two respects: first, how the Act will affect tax revenues; and second, how the Act will affect public assistance costs.

---

[1] See, e.g., Rev. Rul. 79-220, 1979-2 C.B. 74; Rev. Rul. 77-230, 1977-2 C.B 214. In addition, private rulings have concluded that an assignee of the defendant or of the defendant's insurer may also make the periodic payments with no adverse tax consequences. Increasingly, the federal government (the armed services, Amtrak, the Veterans Administration and the Torts Branch, Civil Division of the Department of Justice) is utilizing periodic payments to settle cases, both directly and through assignees. Such settlements have been used also by a wide number of state and local governments and governmental units (e.g., transit districts) as well as private casualty insurers. While the language and structure of the Code and published and private rulings have been followed carefully in those settlements, their tax consequences could be determined definitively only by individual private rulings. Codification of the above rulings is necessary to obviate the need for additional rulings.

A. Tax revenues unaffected

Since the Act is merely a codification of existing law, there will be no incremental loss of tax revenues by passage of the Act. Compensation for personal injuries does not constitute gross income, whether received as a single payment or as periodic payments.[2]

The use of periodic payment settlements will probably increase in the future, but the eventual volume of such settlements will probably not comprise a significant portion of liability claims unless two limitations are removed.[3] First, state statutes mandating settlements for periodic payments would have to be enacted.[4] The enactment of such statutes does not appear likely due to opposition from parts of the bar that fear such statutes would limit legal fees. Second, eighty to ninety percent of liability claims are too small (less than $100,000.00) or otherwise inappropriate for such treatment because they do not relate to future losses.

B. Public assistance costs reduced

The use of a periodic payment settlement assures the availability of future compensation for lost support and care as those costs are incurred. Plaintiffs receiving periodic payments truly are protected from their own ill-conceived actions and the advice of others. If a payment or several payments are dissipated, future compensation for future costs continues to be available. Overall, the periodic payment of damages produces a substantial public advantage.

In many cases, lump-sum settlements have been dissipated within five years although calculated to compensate for losses that extend far into the future. Thus, such losses are paid for initially by insurance premiums (or the general resources of self-insureds), but society as a whole through general taxation may have to meet at least a portion of those losses through welfare or public assistance programs.

In most instances, the only resource that plaintiffs have to mitigate their lost earning capacity and to pay for future medical care is their right to compensation for their injuries. Without that compensation, those persons would subsist on some form of welfare and receive Medicare or Medicaid benefits. Rarely do injured persons or their dependent families have sufficient collateral resources (private insurance, employer disability-survivorship benefits, social security, etc.) to mitigate their economic losses. The payment of a substantial lump sum often does not mitigate those economic losses in the long run, even if the amounts are theoretically adequate, because few people are capable of investing a large lump sum to assure security, liquidity, and an appropriate rate of return for their future needs. They often are ill-advised by friends, relatives, and even professional managers, and some are natural spend-thrifts in any event.

3. CONCLUSION

The changes made by the Act to Code sections 104 and 162 are limited to periodic payment settlements in personal injury litigation and merely confirm existing law in order to eliminate the requirement that a private ruling be obtained. No revenue loss to the Treasury is created by the Act and some reduction may be anticipated in public assistance costs to support recipients of lump-sum payments.

Mr. HIGGINS. I would—before I get into the testimony, I would like to say that we were a little bit surprised by the Treasury position this morning. We thought we had worked out with the Treasury amendments to take care of their concerns.

---

[2] It also should be noted that a substantial number of settlements are designed to offset expected future medical costs that otherwise would be deductible expenses. If the plaintiff does not receive taxable income, the medical expenses are not deductible. See Rev. Rul. 79-427, 1979-2 C.B. 120. Similarly, payments received are taxable income if they relate to medical expenses deducted in prior years. Treas. Reg. § 1.213-1(g) (1956); Rev. Rul. 75-230, 1975-1 C.B. 93. The Act does not change those rules.

[3] The principal use of periodic payment settlements has been for industrial accidents and sickness covered by state workers' compensation laws. Such laws were enacted as early as 1910 to replace (without consideration of fault) a worker's lost earning capacity as that loss is incurred—i.e., over his or her work-life expectancy or natural-life expectancy (if the disability affects retirement as well). In addition, those statutes provide for medical care as it is needed. In most states, lump-sum payments are provided as death benefits and in controverted cases (e.g., where the degree of disability is disputed or applicability of coverage is at issue).

[4] In a few states, such as California, legislation has been enacted applying periodic payments to particular liability areas. From time to time, steps have been taken in other states to enact statutes mandating settlements for period payments as part of broader reforms relating to medical malpractice.

As Mr. Chapoton said, he is still willing to do that. So are we. We are not trying to do anything different from current law. We want very much to put whatever is in the bill that is necessary to make the Treasury concerns go away.

Mr. MATSUI. May I—it appears that you want something in exchange for a codification of the law as it currently exists. He was talking about, maybe you can correct me, the interest that accrues on the periodic payments that goes to the plaintiff. He wants that to be or appears to want that interest to be taxable or at least look into the possibility of making that interest taxable.

I would imagine that your position, indeed the position of every plaintiff's lawyer in the country, would be just the opposite. Is that true?

Mr. HIGGINS. Well, I think the Treasury has misread this bill. I think they have not studied it enough to appreciate what this does. It is a new industry and new arrangements for settling cases, and I do not think they appreciate how it works.

If a plaintiff is promised a lump sum and receives a lump sum and turns around and invests it, the plaintiff is taxable on the income from that lump sum. If you have a plaintiff whose injuries are severe, a quadruplegic for example—I have a case in my office of a 20-year-old lady injured riding around in a State car in Hawaii; she was a bright young person, will never earn another nickel in her life unless she is extraordinarily imaginative—every year that goes by he or she is damaged. The proper way to compensate her is not say here is $10 million dollars, but do not come back in 5 years if it is gone because you got bad advice.

The proper way is to figure out how she is damaged every year and promise to pay her that amount. If you have a defendant willing to do that, we do not need that legislation.

But it is darn hard to find a defendant that is willing to say "as long as this girl is alive, I have to make these payments to her." How does a defendant do that? It is not an insurance company. It manufactures widgets and its widget injured her and she should be compensated, but a defendant does not know how to do it. It cannot create a system that will permit her to receive those payments over her life, even though that is how she is damaged.

The answer is that the defendant assigns the obligation to somebody who knows how to fund that sort of obligation. If the person to whom that obligation is assigned goes out and buys a Treasury bond and uses the earnings on that Treasury bond to pay the obligation to the injured girl, then the income that that assignee earns on the Treasury bond is fully taxable to it and if the assignee pays to the injured girl, the assignee has a deduction.

If the assignee buys two Treasury bonds and earns more than is necessary to pay then injured girl, the taxable income results to that assignee. That is the same result that would occur if the assignee were not there. If the widget manufacturer bought the bond, it would get income from the bond and a deduction for the payment out. If it earned more than it needed to make the payment, it would get less of a deduction and be taxed on the difference.

All our bill attempts to do is to put the assignee in the shoes of the defendant and the only reason that these assignees exist in this world is because the defendants will not enter into those kinds of arrangements, because they are not in the business of making long, extended obligations to pay personal injuries.

There is annual tax inclusion and deduction that has to be performed, there is the problem of keeping open a claims file for that period of time and there is annual accounting that has to be done. Historically, both tortfeasors and their insurers, to get rid of a case, cut a check and walk away. When you suggest to them that they have to stay on the hook for 30 years, they throw up their hands and say "I am sorry, let's go to trial." That is just not the kind of system that we should be using to compensate severely injured plaintiffs.

Now, as I say, I am hopeful we can work out with Treasury their objections because we certainly are not in here looking for anything special. We do not want any excess deductions and we do not want any extraordinary exclusions, we want to step into the shoes of the defendant when they enter into a settlement.

Mr. MATSUI. It sounds like the Treasury and you do not really disagree with their position from what you are telling me now. Maybe there was a midunderstanding in terms of the last scenario that you gave. Is that my understanding?

Mr. HIGGINS. I hope what you just said is correct. However when I listened to Mr. Chapoton this morning, I took away the view that perhaps they want to tell this injured girl, no matter what her recovery is, even if her only promise is to receive $10,000 a year, the Treasury would like to treat her as if she received a lump sum, even though she did not receive a lump sum, and cause some part of that $10,000 to be taxes as a part of the recovery of capital, and that is a most extraordinary result.

Mr. MATSUI. Maybe that very well could be what he meant.

Mr. HIGGINS. It certainly flies in the face of the policy of section 104, which says that compensation for personal injuries is excludable. The compensation that the injured girl has is for damage that accrues annually. She was not damanged as lump sum and should not be paid as a lump sum. She is damaged every year that goes by after that injury. So that is how she should be compensated. The Treasury view is a change of the existing statute.

Chairman STARK. If somebody takes an annuity contract as a settlement, is there a problem with the exising clause? In other words, if I am injured and you, instead of handing me $100,000, you buy the annuity contract for $100,000.

Mr. HIGGINS. Unfortunately the answer to that turns upon the policy. If you were injured and I turned over to you an annuity policy and said "congratulations, here is an annuity policy, it is now yours," the Treasury would tax you, and I think properly so, on the income element in the return of that annuity. They would say your compensation for the personal injury is the present value of that policy.

If on the other hand I said to you——

Chairman STARK. Is not the present value of that about what it costs?

Mr. HIGGINS. Yes.

Chairman STARK. And I am taxed on the whole present value?

Mr. HIGGINS. That is excludable as compensation for personal injuries, but the future income is earnings on the annuity——

Chairman STARK. Not structured as a percentage? Is that how they tax it?

Mr. HIGGINS. They use an exclusion ratio.

Chairman STARK. That is the way it is taxed—if I take the money and buy the contract, I am free.

Mr. HIGGINS. If you are suing me and I say to you, "Mr. Stark, I understand your injuries will be about $10,000 a year for the rest of your life, I agree to pay you that. Give me a release." If that happens, the $10,000 is excludable from your income, because that is compensation for your injury.

Then if I turn around and go to an insurance company and say "how much is it going to cost me to buy an annuity on Mr. Stark's life," that is not your business. I get taxed on the return on that annuity and get a deduction for the payment out to you.

I own the annuity policy, I receive the payments. So the way I fund my obligation is really no concern of yours, unless you own the annuity policy or are the named beneficiary.

Chairman STARK. But you could figure out how much it is going to cost to buy the annuity policy, unless I look pretty shakey, basically you could say, it is going to cost $100,000 to buy that annuity contract for you, here is $100,000, I take the $100,000 tax free, right, from you?

It is a lump sum settlement. I can go buy an annuity with it and I pay the tax consequences.

Mr. HIGGINS. That would make me happy as a defendant because I could cut my check and walk away.

Chairman STARK. How do people who do this who are not insurance companies, how do they get compensated, by a fee?

Mr. HIGGINS. The normal arrangement is if I were to pay you $10,000 a year but I am a widget manufacturer and you were hurt by my widget, the concept of having you as my creditor every year makes me uneasy. I would look to one of the existing companies and say, "How much would you charge me for you to take care of this? I will give you $100,000 but I do not want to see Mr. Stark ever again."

That structured settlement company would say, "Yes; we will assume the obligation provided we can satisfy ourselves an annuity can be purchased that will meet that obligation and provided you pay us something like 2 percent of the present value of that annuity."

Chairman STARK. So they are not wishing me bad luck every day, they do not get windfall profits if I kick off?

Mr. HIGGINS. No, these companies generally create an obligation that exactly meets the method they use to fund it. If they buy an annuity they will buy it for exactly the amount transferred from a defendant getting off the hook and it will yield exactly what——

Chairman STARK. There was some discussion this morning that third party people would be getting some tax-free benefits and in other words, in these structured settlements, there is a fee up front that takes care of setting it all up and beyond that they become a conduit.

Mr. HIGGINS. They assure themselves that their obligation is fully funded with the amount they receive from the defendant. No plaintiff would go along with any other arrangement. These companies are very astute financially in funding obligations.

Chairman STARK. So I am generally looking to the underlying—asset that funds my payments just a credit of the structured settlement company, or do they usually pledge the contract with stocks and bonds or whatever they may be funding?

Mr. HIGGINS. They pledge nothing. The plaintiffs are always by specific written ageement mere general creditors. If you have a bankruptcy of a structured settlement company, the creditors have access to all of the funds set aside by the structured settlement company to meet its obligations. That is necessary because of the traditional doctrine of constructive receipt.

If you give a plaintiff a secured interest in an annuity or trust or set of bonds, he has got the economic current benefit and will be taxed on future income. Indeed, the bill reflects all of these principles in its terms because we are not trying to change the structured sequence of the benefit. We are trying to put them in the same position as an original tortfeasor did in meeting those obligations.

No change in current law.

Chairman STARK. You are saying that I do not have claim to any specific assets.

Mr. HIGGINS. Right.

Chairman STARK. Then really they are annuitants?

Mr. HIGGINS. They are general creditors of the structured settlement company.

Chairman STARK. What is the difference?

Mr. HIGGINS. An annuitant is a person named on an annuity policy to receive payments.

Chairman STARK. When you come right down to it, what is the difference if I get $10,000 a month from Travelers Life Insurance Co., as an annuity. Travelers does not have any special assets pledged so I am trusting that Travelers will take care of me. If they go bankrupt, I stand in line like everybody else. What is the difference, to me as the recipient, between that and a contract with a structured settlement company?

Mr. HIGGINS. Your status as a general creditor is no different.

Chairman STARK. So I am in no different position.

Mr. HIGGINS. Yes.

Chairman STARK. Except one is regulated generally by a State, and I presume that the structured settlement people are not.

Mr. HIGGINS. That is right.

Chairman STARK. Would this bill then put the insurance company and the structured settlement company on the same basis?

Mr. HIGGINS. Well, the taxation of insurance companies is very complicated.

Chairman STARK. Just relative to settlement. I am getting my $100,000 worth of settlement. Obviously one is cheaper in a tax dollar sense than the other, and I will get a bigger settlement.

Is there any tax reason why—you are the guy who owes me the money. Is there a tax incentive for you to use a structured settlement as opposed to annuity?

Mr. HIGGINS. No.

Chairman STARK. No tax advantage one way or the other?

Mr. HIGGINS. Right.

Chairman STARK. So we are not sticking it to the insurance companies?

Mr. HIGGINS. No.

Chairman STARK. Is there anything else that ought to be added for the record? I was unclear what Mr. Chapoton was talking about the third party tax advantage.

Mr. HIGGINS. The only point I heard Mr. Chapoton articulate this morning that really concerns me is his view that maybe a fundamental reconsideration of section 104 is appropriate. I hadn't heard that articulated before. I am hopeful that we could work out with Treasury all of the points he made this morning.

Chairman STARK. The staff brought up one other question. As I understand, in the State of California, in certain instances, the court now requires periodic payments.

Mr. HIGGINS. There is a move in many States.

Chairman STARK. Is that at odds with Federal tax legislation?

Mr. HIGGINS. It would be at odds if Mr. Chapoton's proposed fundamental change were enacted but not at this moment, no. It certainly should not be. These people are damaged periodically. They should be paid periodically.

Mr. CORMAN. If I may, there seem to be two objections or one objection and one uncertainty on the part of Treasury. The first one is that they were not certain that the legislative language as was introduced at the Jacob's bill did precisely and only what the parties were after.

Mr. Higgins and Mr. Pike discussed some proposed amendments, submitted them. It was his understanding that those met those technical objections. When it was written up those amendments would go in because they clarify with certainty that you do not go beyond existing law.

There seem to be questions this morning as to whether o. not Treasury wanted to stick with the letter rulings which have come out over the past several years because it was the original objective the legislation would only codify those.

Treasury goes back and questions the basic philosophy and then we have a philosophic discussion rather than a technical one. The philosophic discussion is, is it in the public interest, when you have a severely injured person, to make it possible for them to be compensated over a relatively long period of time and not introduce into this subject matter tax disincentives for that purpose?

We believe that the results of that sort of consideration, that we would prevail with this committee and with Congress.

Chairman STARK. Let me ask this. In these negotiated settlements—take the airline crash, for instance, say there are 100 passengers and somebody tries to negotiate out of the whole 100, can one of the 100 refuse to participate, and demand cash?

Mr. HIGGINS. Those massive personal injury catastrophic occasions like the airline crashes, the asbestos litigation, the MGM Grand fire, those are always handled on a claimant-by-claimant basis. Every claimant gets his day in court. Some claimants want to go to trial and get a lump sum jury verdict. Some want a lump sum settlement. Where State statutes permit, some try to get periodic judgments. It is entirely individual claims.

Mr. MATSUI. Mr. Chairman, undoubtedly I will have to get a clarification from Mr. Chapoton. I thought it was the excess of any moneys that would be derived from the amount of the lump sum that Chapoton was talking about taxing rather than the entire $10,000, let's say, that would go to the plaintiff. I think you interpreted that the entire $10,000 would be taxable.

Reading over the last paragraph of his report, I think I would agree with your interpretation right now, which would fundamentally alter the law.

Mr. HIGGINS. It is extraordinary.

Mr. MATSUI. We should probably get clarification.

Chairman STARK. Gentlemen, thank you for your patience, we appreciate it. There may be some more questions that other members wish to submit to you which you can provide the answers for the record.

[Whereupon, at 4:55 p.m., the subcommittee adjourned, subject to call of the Chair.]

APPENDIX

There follows the text, summary and description, and written communications received on each of the bills under consideration.

Charitable Contributions of Certain Inventory to Scientific Research Organizations

97TH CONGRESS
1ST SESSION

H. R. 4667

To amend the Internal Revenue Code of 1954 to include certain tax-exempt organizations as eligible recipients of scientific property for purposes of the special computation of the charitable contribution deduction for such property.

IN THE HOUSE OF REPRESENTATIVES

OCTOBER 2, 1981

Mr. GUARINI (for himself, Mr. FORSYTHE, Mr. HOWARD, Mr. FLORIO, Mr. ROE, and Mr. RINALDO) introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To amend the Internal Revenue Code of 1954 to include certain tax-exempt organizations as eligible recipients of scientific property for purposes of the special computation of the charitable contribution deduction for such property.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) clause (i) of section 170(e)(4)(B) of the Internal Revenue Code of 1954 (relating to special rule for contributions of scientific property used for research) is amended to read as follows:

"(i) the contribution is to a qualified organization,".

(b) Paragraph (4) of section 170(e) of such Code is amended by redesignating subparagraphs (C) and (D) as subparagraphs (D) and (E), respectively, and by inserting after subparagraph (B) the following new subparagraph:

"(C) QUALIFIED ORGANIZATION.—For purposes of subparagraph (B), the term 'qualified organization' means—

"(i) an educational organization which is described in subsection (b)(1)(A)(ii) of this section and which is an institution of higher education (as defined in section 3304(f)), and

"(ii) any other organization which—

"(I) is described in section 501(c)(3) and exempt from tax under section 501(a),

"(II) is organized and operated primarily to conduct scientific research, and

"(III) is not a private foundation."

(c) The amendments made by this Act shall apply to charitable contributions made after August 13, 1981, in taxable years ending after such date.

SUMMARY AND DESCRIPTION

PRESENT LAW

Contributions by corporations

A corporation may deduct, within certain limitations, the amount of cash or other property contributed to qualified charitable organizations (Code sec. 170). This charitable deduction is limited to 10 percent of the corporation's taxable income (computed with certain adjustments) for the year in which the contributions are made. If the amount contributed exceeds the percentage limitation, the excess may be carried forward and deducted over five succeeding years, subject to the percentage limitation in those years.

Reduction in contribution amount

The amount of charitable deduction otherwise allowable for donated property generally must be reduced by the amount of any ordinary income which the donor would have realized had the property been sold for its fair market value at the date of the contribution (sec. 170(e)).[1] Thus, a donor of appreciated ordinary-income property (property the sale of which would not give rise to long-term capital gain) generally may deduct only the donor's basis in the property, rather than the fair market value. For example, a manufacturer which donates a product from its inventory generally may deduct only its inventory cost for the item.

Special rules for certain corporate contributions

Under present law, charitable contributions of two types of ordinary-income property, if donated to certain exempt organizations for specified purposes, are subject to a different reduction rule. The first exception, enacted in the Tax Reform Act of 1976, is for corporate donations of ordinary-income property to a charitable organization to be used solely for care of the needy, the ill, or infants (such as donations by the producer or manufacturer of food, clothing, or medical equipment), where such use is related to the donee's charitable functions (sec. 170(e)(3)). The second exception, enacted in the Economic Recovery Tax Act of 1981, is for corporate donations of newly manufactured scientific equipment to a college or university to be used for research (or research training) in the United States in the physical or biological sciences (sec. 170(e)(4)).

In the case of a charitable contribution of inventory which qualifies under one of these exceptions, the corporate donor generally is allowed a deduction equal to the sum of its basis in the property plus one-half of the unrealized appreciation (i.e., the difference between fair market value and basis). However, in no event is a deduction allowed for an amount in excess of twice the basis of the property (sec. 170(e) (3)(B)).

These two exceptions were enacted because the Congress concluded that it was desirable to provide a larger tax incentive than would be available if the general reduction rule applied for charitable contributions by corporations of certain ordinary-income property to specified types of charities for particular purposes. At the same time, the Congress also determined that the deduction so allowed should not be such that the donor could be in a better after-tax situation by donating the property than by selling it.

ISSUE

The issue is whether an exception to the general reduction rule (applicable to charitable contributions of ordinary-income property) should be provided for corporate contributions of newly manufactured scientific equipment to certain tax-exempt scientific research organizations; i.e., should any deduction in excess of the cost of the goods to the donor be allowed.

EXPLANATION OF THE BILL

General rule

The bill would allow corporations (with certain exceptions)[2] a larger deduction than under present law for certain charitable contributions of new tangible personal property which is of an inventory nature (within the meaning of sec. 1221(1)), if contributed to an organization which is operated primarily to conduct scientific research, which is exempt from Federal income tax under section 501(c)(3), and which is not a private foundation.

---

[1] In the case of donations of tangible capital gain property, the amount taken into account as a charitable contribution must be reduced by a portion of the appreciation if the use of the donated item by the donee charity is unrelated to the charity's exempt functions, or if the property is given to certain types of private foundations.

[2] The provision does not apply in the case of a corporation which is a subchapter S corporation, as defined in sec. 1371(b); a personal holding company, as defined in sec. 542; or a service organization, as defined in sec. 414(m)(3).

Requirements for favorable treatment

To qualify, a corporate contribution of ordinary-income property to a tax-exempt scientific research organization must satisfy the following requirements:

(1) The property contributed was constructed by the donor; [3]

(2) The contribution is made within two years of substantial completion of construction of the property;

(3) The original use of the property is by the research organization;

(4) The property is scientific equipment or apparatus substantially all the use of which by the donee is for research or experimentation (which the meaning of sec. 174), or for research training, in the United States in the physical or biological sciences; [4]

(5) The donated property is not transferred by the research organization in exchange for money, other property, or services; and

(6) The donor receives the research organization's written statement representing that the use and disposition of the property contributed will be in accordance with the last two requirements.

Allowable deduction

If all the conditions are satisfied, the charitable deduction allowed by the bill generally would be for the sum of (1) the taxpayer's basis in the property, plus (2) one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value [5] determined at the time of the contribution and the donor's basis in the property). However, in no event would a deduction be allowed for any amount in excess of twice the basis of the property.

For example, if a manufacturer makes a qualifying contribution to a scientific research organization of an electron microscope with a cost basis of $\$5X$, and a fair market value of $\$16X$, the bill would allow the manufacturer a charitable deduction of $\$10X$ (twice the $\$5X$ basis). Assuming a 46 percent tax bracket, the effect of the deduction under the bill would be to reduce the manufacturer's tax liability by $\$4.6X$, or 92 percent of the cost of manufacture. The out-out-pocket cost of the donation to the manufacturer, exclusive of distribution and other expenses, would then be $\$0.4X$, or 8 percent of the manufacturer's cost. If in the example the fair market value of the electron microscope was $\$11X$, the deduction would be $\$8X$ ($\$5X$ basis plus ½ of the $\$6X$ difference between value and basis), and the out-of-pocket cost to the manufacturer would be $\$1.32X$ ($\$5X$ cost less $\$3.68X$ tax benefit).

EFFECTIVE DATE

The provisions of the bill would apply retroactively to charitable contributions made after August 13, 1981 (the effective date for the provision enacted in the Economic Recovery Tax Act of 1981 for corporate donations of newly manufactured scientific equipment to a college or university for research use).

REVENUE EFFECT

It is estimated that the bill would reduce fiscal year budget receipts by less than $5 million annually.

---

[3] Under Treasury regulations, property is to be treated as constructed by the taxpayer only if the cost of parts (other than parts manufactured by the taxpayer or a related person) used in construction do not exceed 50 percent of the taxpayer's basis in the property.

[4] For purposes of the fourth requirement listed above, the term "substantially all" means at least 80 percent.

[5] Where donated property is of a type which the taxpayer sells in the course of its business, the fair market value is the price which the taxpayer would have received if the taxpayer had sold the contributed property in the usual market in which it customarily sells, at the time and place of the contribution and, in the case of a contribution of goods in quantity, in the quantity contributed. The usual market of a manufacturer or other producer consists of the wholesalers or other distributors to or through whom it customerily sells; but if it sells only at retail, the usual market consists of its retail customers (Reg. § 170A-1(c)(2)).

Extension of Cash and Deferred Plan Rules to Salary Reduction Arrangements Under Money Purchase Pension Plans

97TH CONGRESS
1ST SESSION

H. R. 4948

To amend the Internal Revenue Code of 1954 to provide for the application of cash or deferred arrangement rules to money purchase plans.

IN THE HOUSE OF REPRESENTATIVES

NOVEMBER 12, 1981

Mr. MATSUI introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To amend the Internal Revenue Code of 1954 to provide for the application of cash or deferred arrangement rules to money purchase plans.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. GENERAL RULE.

Subsection (k) of section 401 of the Internal Revenue Code of 1954 (relating to cash or deferred arrangements) is amended—

(1) by adding at the end of paragraph (1) the following new sentence: "A money purchase pension plan

shall not be considered as not satisfying the requirements of subsection (a) merely because the plan includes a qualified salary reduction arrangement.",

(2) by inserting after "arrangement" in paragraph (3)(A) the following: "under a profit-sharing or stock bonus plan, or a qualified salary reduction arrangement under a money purchase pension plan,", and

(3) by adding at the end thereof the following new paragraph:

"(5) QUALIFIED SALARY REDUCTION ARRANGEMENT.—

"(A) IN GENERAL.—A qualified salary reduction arrangement is an arrangement, under a money purchase pension plan—

"(i) under which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash, and

"(ii) which provides that an employee's right to his accrued benefit derived from employer contributions made to the trust pursuant to his election is nonforfeitable.

"(B) MONEY PURCHASE PENSION PLAN.—For purposes of this subsection, the term 'money purchase pension plan' means a pension plan—

"(i) which is a defined contribution plan (as defined in section 414(i)),

"(ii) which was in existence on June 27, 1974, and which, on that date, included a salary reduction arrangement, and

"(iii) under which neither the employee contributions nor the employer contributions may exceed the levels provided for by the contribution formula in effect under the plan on that date."

SEC. 2. TAXABILITY OF BENEFICIARIES.

Paragraph (8) of section 402(a) of the Internal Revenue Code of 1954 (relating to cash or deferred arrangements) is amended by inserting after "(as defined in section 401(k)(2))" the following: ", or a qualified salary reduction arrangement under a money purchase pension plan (as defined in section 401(k)(5)),".

SEC. 3. CONFORMING AMENDMENTS.

(a) The caption of subsection (k) of section 401 of the Internal Revenue Code of 1954 is amended by inserting "; QUALIFIED MONEY PURCHASE PENSION PLAN" after "ARRANGEMENTS".

(b) The caption of paragraph (8) of section 402(a) of such Code is amended by inserting "; QUALIFIED MONEY PURCHASE PENSION PLAN" after "ARRANGEMENTS".

SEC. 4. EFFECTIVE DATE.

(a) IN GENERAL.—The amendments made by section 1 shall apply with respect to taxable years beginning after December 31, 1980. The amendment made by section 2 shall apply with respect to contributions made after that date. The amendments made by section 3 shall take effect on the date of enactment of this Act.

(b) TRANSITION RULE.—Any contribution made after December 31, 1979, and before the first day of the first plan year beginning after December 31, 1980, to a trust under a plan which includes a salary reduction plan or arrangement described in section 2006(b)(2) of the Employee Retirement Income Security Act of 1974 shall be treated as made to a trust which is part of a plan which includes a qualified salary reduction arrangement (as defined in section 401(k)(5) of the Internal Revenue Code of 1954), whether or not the trust to which the contribution is made meets the requirements of section 401(k)(5) of such Code.

SUMMARY AND DESCRIPTION

BACKGROUND AND PRESENT LAW

In general

A money purchase pension plan is a defined contribution plan under which each participant's pension benefit is based solely on the balance of the participant's account, consisting of contributions, income, gain, expenses, loss, and forfeitures allocated from the accounts of other participants.[1] Profit-sharing plans are also defined contribution plans.

Under a cash or deferred profit-sharing plan, or under a money purchase pension plan with a salary reduction arrangement, the employer gives an employee the choice of (1) receiving a specified amount in cash as current compensation or (2) having that amount contributed to the plan.

In December 1972, the Internal Revenue Service issued proposed regulations which called into question the tax treatment of cash or deferred profit-sharing plans and money purchase pension plans with salary reduction arrangements. (These proposed regulations were withdrawn in July 1978). Under the rules in effect at the time of the proposal, an employee generally was not taxed currently on amounts the employee chose to have contributed to a tax-qualified cash or deferred profit-sharing plan or salary reduction money purchase pension plan. Under the proposed regulations, amounts contributed to a plan due to the election of the employee would be included in the employee's income.

Freeze on tax treatment

In order to allow time for Congressional study of this area, the Employee Retirement Income Security Act of 1974 (ERISA) provided that the tax treatment of contributions to cash or deferred profit-sharing plans or salary reduction money purchase plans in existence on June 27, 1974 was to be governed under the law as it was applied prior to January 11, 1972. Accordingly, employer contributions to these cash or deferred profit-sharing plans were not includible in the income of covered employees, provided the plans satisfied the requirements of pre-1972 law and otherwise complied with the taxqualification rules. Under ERISA, this freeze in tax treatment was continued through 1976, or (if later) until regulations were issued in final form which would change the pre-1972 administration of the law. The freeze was subsequently extended through 1979.

Revenue Act of 1978

The Revenue Act of 1978 provided rules for new and old profit-sharing plans with cash or deferred arrangements. The new rules, which also apply to stock bonus plans, are effective for plan years beginning after 1979. For years beginning before 1980, the tax treatment under a plan in existence on June 27, 1974, is determined under prior law. No new rules were provided by the 1978 Act for salary reduction arrangements under money purchase pension plans.

ISSUE

The principal issue is whether the tax-qualification rules should permit salary reduction arrangements under money purchase pension plans on the same basis as cash or deferred arrangements are permitted under profit-sharing and stock bonus plans.

EXPLANATION OF THE BILL

The bill would revise the tax-qualification rules to permit a qualified money purchase pension plan which was in existence on June 27,1974, and which provided for salary reduction arrangement on that date, to continue the arrangement after 1979. However, the bill's revision to the tax-qualification rules would apply only to those money purchase pension plans under which employer and employee contributions may not exceed the levels (e.g., as a percentage of pay) provided under the plan's contribution formula on June 27, 1974.

In addition, for plan years beginning after 1979, a salary reduction arrangement under a money purchase pension plan would be required to meet the special tax-qualification rules for cash or deferred arrangements added by the 1978 Act with respect to employee eligibility to participate in the arrangement and to prohibited discrimination in favor of employees who are officers, shareholders, or highly compensated. These rules presently apply to cash or deferred arrangements under qualified profit-sharing or stock bonus plans.

---

[1] Under a defined benefit pension plan, a participant's benefit is specified independently of an account for contributions, etc. (e.g., an annual benefit of two percent of average pay for each year of employee service).

The provisions of the bill would apply to salary reduction arrangements under money purchase pension plans of taxable employers and tax-exempt organizations.

EFFECTIVE DATE

The bill would apply retroactively for plan years beginning after December 31, 1980, and to contributions made after that date. A transition rule is provided for contributions made after 1979, and before the beginning of the first year beginning after 1980.

REVENUE EFFECT

An estimate of the effect of the bill on budget receipts is not available at this time.

STATEMENT OF HON. ROBERT T. MATSUI, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Chairman and members of the subcommittee, H.R. 4948 addresses an anomaly existing pension tax law. An anomaly which discriminates severely against nonprofit organizations and tax-exempt.

Existing law recognizes three distinct types of pension plans that are accorded favorable tax treatment. They are profit sharing plans, stock bonus plans, and money purchase pension plans. One means for funding these three pension plans is through a cash or deferred arrangement. Under such an arrangement, an employee is given the choice of receiving a stipulated amount of cash as current compensation or of contributing all or part of that amount to a retirement plan.

Prior to 1972, elective contributions under a cash or deferred arrangement were ot taxed currently to plan participants. Although the Treasury Department in 1972 proposed to subject these plans to immediate taxation, ERISA stayed the implementation of these regulations until the Congress could review the matter further.

The Revenue Act of 1978 provided permanent protection for qualified cash or deferred arrangements under profit sharing or stock bonus plans. Elective contributions under these arrangements are not fixed currently to plan participants if the plans meet the statutory standards relating to nondiscrimination in participation and contribution, vesting, and timing of plan distributions. The 1978 Act, however, did not provide any permanent protection for money purchase pension plans containing cash or deferred arrangements. Moreover, those plans in existence as of June 27, 1974, which were previously protected under ERISA were not afforded any protection.

This distinction between profit sharing and money purchase plans with qualified cash or deferred arrangements appears not to be based on sound policy. This inequality is important in that money purchase pension plans are the principal means by which small tax-exempt and non-profit organizations provide for the retirements needs of their employees. Tax-exempt organizations are precluded from participating in profit sharing or stock bonus plans due to their non-profit and non-stock issuance status. We will hear testimony today on behalf of a town administrator of a small Maryland town on exactly this point.

H.R. 4948 proposes to place money purchase pension plans with cash or deferred arrangements on parity with these other pension plans. The 1978 Revenue Act nondiscrimination standards applicable to stock or profit plans would be extended to money purchase pension plans. Therefore, participants making elective contributions to money purchase pension plans under cash or deferred arrangements would be accorded favorable tax treatment only where the plans meet the requirements that the 1978 Act imposed on profit sharing and stock bonus plans.

Money purchase pension plan participants with cash or deferred arrangements in existence on June 27, 1974, would be grandfathered in; however, their level of contribution would be frozen at the 1974 rate. Grandfathering of these plans prevents disruption of retirement plans for those persons who had relied on the controlling law. Similar treatment was afforded to stock bonus and profit sharing in the 1978 Act.

It is most appropriate that the Congress proceeds to address this problem immediately. Pending Treasury regulations will require all employees who participate in salary reduction money purchase pension plans to include in their gross income all contributions made after December 31, 1979. At a time when the Congress has adopted a strong public policy in favor of employee contributions to retirement plans, it would be most inequitable to abandon those employees who have in good faith been participating in a common and valid retirement program.

ORANGE LEADER PUBLISHING CO.,
Orange, Tex., February 17, 1982.

Hon. CHARLES WILSON,
Longworth House Office Building,
Washington, D.C.

DEAR CHARLIE: This is an urgent and fervent plea for your assistance with a problem that threatens serious disruption of our employee retirement program with a consequent further erosion of the confidence of our people in the federal government and the bureaucracy it has spawned.

Regretfully, we must go into some detail in order to give you adequate background on the problem and its potentially mischievous effect on the retirement benefits of our employees.

Long before there was widespread recognition of the fact that retirement programs should be a three-legged stool propped up by (1) Social Security, (2) employer-funded benefits and (3) personal savings, the Orange Leader Publishing Co. moved to erect such a structure.

In 1962, it set up a profit-sharing plan to which it is making generous annual contributions. This was supplemented with a past-service annuities plan providing supplemental retirement income to employees who had been with the company five years or longer when the profit-sharing plan was established. Employees contribute nothing to these plans.

By 1972, it had become obvious to us that because of rampaging inflation something more was needed—something that would encourage our employees to become more active in providing the third leg of the stool.

In that year, we set up a salary reduction money purchase pension plan in which our people, at their option, may participate. We have in our files two favorable determination letters from the Internal Revenue Service, one dated July 11, 1972, and the other dated July 19, 1977.

At the present time, there are 26 participants in this plan, some from the outset, others from one to nine years. In the aggregate, through the salary reduction agreements, there has been contributed to the plan on their behalf $80,503. Of that total, $32,532 has been contributed since Jan. 1, 1980. The significance of that date will appear later on.

As of this date, the trust holds 33,893.996 shares of a mutual funds stock with a net asset value of $115,240. In addition, the participants have cash value life insurance with fixed death benefits totaling $190,961 and a current cash value of $18,640, bringing their total current equity to $133,880.

It is obvious from these numbers that this is an excellent plan. It would be very distressing to the participants and to the company if we have to terminate it, but we may, and here is why:

IRS is proposing to end the favorable tax treatment previously afforded this plan as addressed in § 2006 of the Employee Retirement Income Security Act of 1974 ("ERISA").

ERISA § 2006 barred the IRS from issuing regulations on salary reduction plans until Jan. 1, 1977 (extended through Dec. 31, 1979 in subsequent legislation). The Conference Committee Joint Explanation of § 2006 indicated that the moratorium on issuing further regulations was to allow time for Congressional study of the matter.

The salary reduction money purchase plan we adopted for our employees has been in effect since March 1, 1972 which under ERISA permitted salary reduction contributions to be treated as employer contributions thus avoiding inclusion in gross income.

Under these arrangements an employee is given the opportunity of irrevocably electing in writing for a plan year to reduce his compensation and have such foregone amount contributed to the money purchase plan. The company makes these contributions monthly and in addition bears all trustee fees and administrative costs.

The ERISA "freeze" on issuance of salary reduction regulations has now expired and the IRS on Nov. 10, 1981 issued proposed regulations on cash or deferred arrangements in qualified profit-sharing or stock bonus plans and regulations relative to when salary reduction contributions would be deemed employee contributions and taxable as income to the employee.

The proposed regulations explicitly permit that a cash or deferred arrangement may be in the form of salary reduction agreement but only in qualified profit-sharing or stock bonus plans. Neither Code § 401(k) added by the Revenue Act of 1978 nor the proposed regulations on § 401(k) or § 402 address the money purchase pension plan salary reduction arrangement.

If the proposed regulations are issued in final form as currently written, salary reduction money purchase pension plans previously protected under ERISA § 2006 and the extensions thereof, will have the amounts contributed pursuant to the salary reduction arrangements taxable as income to the employee-participant retroactive to Jan. 1, 1980.

This not only will be administratively unfeasiable but would cause undue hardship from a tax standpoint on our employees who have had $32,532 contributed to our plan since Jan. 1, 1980.

It also may cause us to terminate our plan since participation no doubt would be substantially reduced if salary reduction contributions were to become taxable.

We find it incredible that Congress overlooked salary reduction money purchase plans in the 1978 Revenue Act, and that the IRS now by retroactive regulation would impose a tax on the salary reduction contributions.

We are seeking both a legislative solution to this problem such as that most recently introduced by Mr. Matsui of the House (H.R. 4948, introduced Nov. 12, 1981), and are requesting that final regulations on Prop. Treas. Reg. § 1.402(a)-1(d) at the lease exempt from inclusion in gross income amounts contributed under a salary reduction money purchase pension plan arrangements which were in effect on or before June 27, 1974.

Your assistance and prompt action in accomplishing these objectives will be greatly appreciated.

Sincerely,

JAMES B. QUIGLEY, *President.*

Conveyance of Certain Lands to Fort Carson as Involuntary Conversions

97TH CONGRESS
1ST SESSION

H. R. 5177

To permit persons who convey certain lands in Colorado to the United States for the expansion of the Fort Carson military installation to treat the conveyance of such lands as involuntary conversions for the purposes of section 1033 of the Internal Revenue Code of 1954.

IN THE HOUSE OF REPRESENTATIVES

DECEMBER 11, 1981

Mr. BRINKLEY introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To permit persons who convey certain lands in Colorado to the United States for the expansion of the Fort Carson military installation to treat the conveyance of such lands as involuntary conversions for the purposes of section 1033 of the Internal Revenue Code of 1954.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That for purposes of section 1033 of the Internal Revenue Code of 1954, any conveyance, other than a conveyance made as a gift, of privately owned lands located in the vicinity of Purgatory River Canyon and Pinon Canyon, Colorado, to the United States for expansion of the Fort Carson military installation shall be treated as an involuntary conversion.

SUMMARY AND DESCRIPTION

PRESENT LAW

Under present law, a taxpayer may elect not to recognize gain realized on the involuntary conversion of property if the taxpayer acquires, within a specified replacement period,[1] property which is similar or related in service or use to the involuntarily converted property (Code sec. 1033). In such a situation, gain is recognized only to the extent that the amount realized exceeds the cost of the replacement property. The basis of the replacement property generally is that of the converted property, decreased by any gain not recognized.

If real property (not including stock in trade or other property held primarily for sale) held for productive use in a trade or business or for investment is involuntarily converted, then property of a "like kind" to be held either for productive use in a trade or business or for investment is treated as property similar or related in service or use to the converted property (sec. 1033(g)(1)). The term "like kind" refers to the nature of character of the property converted.

ISSUE

The issue is whether conveyances (other than by gift) of privately owned lands located in the vicinity of the Purgatory River Canyon and Pinon Canyon, Colorado, to the United States for expansion of the Fort Carson military installation should be treated as involuntary conversions under section 1033, so that the landowners could elect to avoid recognition of gain at the time of the conveyances.

EXPLANATION OF THE BILL

The bill provides that conveyances (other than by gift) to the United States of privately owned lands located in the vicinity of the Purgatory River Canyon and Pinon Canyon, Colorado, for expansion of the Fort Carson military installation would be treated as involuntary conversions under section 1033.

The bill is intended to apply only to those landowners whose land is actually acquired for expansion of Fort Carson under the Military Construction Authorization Act of 1982. The bill would provide involuntary conversion treatment for such conveyances of land whether or not such conveyances otherwise satisfied the technical requirements for involuntary conversion treatment under present law.

FFFECTIVE DATE

The bill would be effective on enactment.

REVENUE EFFECT

An estimate of the effect of the bill on budget receipts is not available at this time.

HOUSE OF REPRESENTATIVES,
Washington, D.C. June 23, 1982.

Hon. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures,
Committee on Ways and Means, Washington, D.C.

DEAR MR. CHAIRMAN: I would like to submit, for the record, my comments in support of H.R. 5177, which was heard before your committee on June 14.

This bill results from a federal purchase of 244,000 acres of private property in the Third Congressional District which I represent. The land will be, over the next several months, purchased by the Department of the Army, for use by Fort Carson and the 4th Mechanized Infantry Division. As a result, several landowners will be displaced.

Many of those landowners, Mr. Chairman, operate ranches on property which has been in their families for many years. In other cases, the property is not presently being used for ranching, but is of considerable value to the landowners who have in some instances made plans for future development of the property.

---

[1] The replacement period is, in general, the period beginning with the date of the disposition of the converted property (or the earliest of the threat or imminence of the condemnation of the converted property, if earlier than the disposition date), and ending two years after the close of the first taxable year in which any part of the gain on conversion is realized.

While I consistently opposed this federal takeover of more Western lands, authority was granted to the Army to pursue this purchase, which in my view, creates hardship for landowners, particularly those in the ranching business. Good ranchland is difficult to locate, and expensive. Added to this factor is the desire of several of the dislocated families to remain in southern Colorado.

Passage of H.R. 5177 would make it less burdensome for those displaced landowners to find property comparable to that which will be taken by the federal government.

I strongly support passage of this legislation. Loss of personal property for any reason is difficult for a landowner to bear, particularly when strong family ties to the area are also considered. I would urge you to favorably report this bill so that the impact of the Army's purchase of this large amount of private property is made just a little more tolerable to those who may find it difficult to relocate as a result of the Army's actions.

Thank you for your consideration.

Sincerely,

RAY KOGOVSEK.

Exclusion From Gross Income of Certain Payments for Personal Injury Damage

97TH CONGRESS
2D SESSION

H. R. 5470

To amend the Internal Revenue Code of 1954 to insure periodic payments for damages received on account of personal injuries or sickness, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 5, 1982

Mr. JACOBS (for himself, Mr. HOLLAND, Mr. GUARINI, Mr. DUNCAN, and Mr. VANDER JAGT) introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To amend the Internal Revenue Code of 1954 to insure periodic payments for damages received on account of personal injuries or sickness, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Periodic Payment Settlement Act of 1982".

SEC. 2.

(a) GROSS INCOME EXCLUSION.—Paragraph (5) of section 104(a) of the Internal Revenue Code of 1954 is amended by substituting for the period a semicolon and adding "and" at the end thereof. The following new paragraph is added following paragraph (5):

"(6) amounts received by an assignee described in subsection (b)(1)(B) and applied by the assignee to satisfy the obligations assigned for payment of damages on account of personal injuries or sickness."

(b) PERIODIC PAYMENTS.—Sections 104(b) and 104(c) of the Internal Revenue Code of 1954 are redenominated 104 (c) and (d), respectively, and the following new section is added following section 104(a):

"(b) DAMAGES RECEIVED AS PERIODIC PAYMENTS.—

"(1) IN GENERAL.—Subsection (a)(2) shall apply to damages received as periodic payments whether received from or through—

"(A) the person originally liable (whether by suit or agreement) for payment of such damages, or

"(B) an assignee of the person originally liable (whether by suit or agreement) for payment of such damages.

"(2) RULES FOR APPLICATION OF SUBSECTION (b)(1)(B).—Subsection (b)(1)(B) shall apply provided the assignee assumes the liability for the periodic payments from the person originally liable (whether by suit or agreement) for payment of such damages and provided—

"(A) the periodic payments from the assignee cannot be accelerated, deferred, increased or decreased by the recipient of such payments,

"(B) the assignee does not provide to the recipient of such payments rights against the assignee that are greater than those of a general creditor, and

"(C) the assignee's obligation on account of the personal injuries or sickness is no greater than the obligation of the person originally liable (whether by suit or agreement) for payment of such damages and from whom the obligation was assigned."

(c) DEDUCTION BY ASSIGNEE.—Section 162(h) of the Internal Revenue Code of 1954 is redenominated 162(i) and the following new section 162(h) is inserted following section 162(g):

"(h) PAYMENT OF DAMAGES BY ASSIGNEE.—The deduction allowed by subsection (a) shall include damages described in section 104(a)(2) paid during the taxable year by an assignee described in section 104(b)."

SEC. 3. EFFECTIVE DATE.

The amendments made by this Act shall apply for taxable years ending after December 31, 1981. The amendments made by this Act are a codification of prior law developed administratively and judicially.

SUMMARY AND DESCRIPTION

PRESENT LAW

In general, present law (Code sec. 104) exludes from gross income the following types of compensation payments for personal injuries or sickness:

(1) certain amounts received under worker's compensation laws (if paid for personal injuries or sickness);

(2) damages received under a suit or settlement of a claim;

(3) amounts received through accident and health insurance (unless received by an employee and either attributable to employer contributions that were not includible in the gross income of the employee, or else paid directly by the employer);

(4) pensions, annuities, or similar allowances for personal injuries or sickness resulting from active service in the armed forces of any country, the Coast and Geodetic Survey, or the Public Health Service, or a disability annuity paid under the Foreign Service Act; and

(5) amounts received as disability income by a United States employee who was injured by terrorist violence while performing official duties outside the United States.

However, to avoid a double tax benefit, an exclusion is not allowed for such compensation payments to the extent attributable to (and not exceeding) deductions allowed to the recipient as medical expenses in a prior year.

Generally, the Internal Revenue Service has ruled that damages for personal injury are excludable from gross income under section 104 whether paid as a lump sum, or paid in periodic payments out of a fund invested and owned by the tortfeasor or an insurer (see Rev. Rul. 77-230, 1977-2 C.B. 214;[1] Rev. Rul. 79-220, 1979-2 C.B. 74;[2] and Rev. Rul. 79-313, 1979-2 C.B. 75).[3] However, the exclusion of damages for personal injury does not apply to investment income generated from a lump-sum award invested by or on behalf of the taxpayer (Rev. Rul. 76-133, 1976-1 C.B. 34).

ISSUES

The principal issue is whether periodic payments of damages for personal injury, whether paid by the person originally liable for such damages or by an assignee of the tortfeasor, should, by express statutory provision, be excluded from the gross income of the recipient. Other issues are whether amounts received by an assignee to fund an obligation to pay damages in periodic payments should be excluded from gross income, and whether amounts paid by such assignee to a recipient of personal injury damages should be deductible as ordinary and necessary business expenses.

EXPLANATION OF THE BILL

The bill would expand the types of compensation payments for personal injuries which are specified in section 104 as excludable from gross income to include amounts received by an assignee of an obligation to pay personal injury damages and used by the assignee to satisfy that obligation.

Also, the bill would statutorily adopt the rulings position of the Internal Revenue Service that the section 104 exclusion applies to certain periodic payments of damages for personal injuries or sickness received from or through either the person originally liable for the damages or an assignee of the person originally liable. This rule would apply only if the assignee is subject to the same rights and liabilities of such person, and only if the recipient cannot accelerate, defer, increase, or decrease the periodic payments from the assignee.

---

[1] Rev. Rul. 77-230 holds that distributions from a trust established and owned by the United States under a settlement agreement stemming from an individual's suit for injuries sustained at a government facility, and requiring payment of the individual's future medical expenses from the income or corpus of the trust, are excludable from the individual's gross income. Under the facts of the ruling, any trust assets (accumulated income or corpus) remaining on the individual's death would revert to the government.

[2] Rev. Rul. 79-220 holds that where the insurer of a tortfeasor purchases and retains exclusive ownership of a single-premium annuity contract to fund specified monthly payments for a fixed period pursuant to settlement of a damage suit for personal injuries, the recipient may exclude from his or her gross income the full amount of the payments, and not merely the discounted present value. The taxpayer's only right with respect to the amount invested was to receive the monthly payments, and the ruling concluded that the taxpayer did not have actual or constructive receipt or economic benefit of the amount invested.

[3] Rev. Rul. 79-313 holds that if, in a personal injury settlement, the insurer of a tortfeasor agrees to make 50 consecutive annual payments (increasing by five percent a year), the entire amount of the payments received is excludable from the recipient's gross income under sec. 104(a)(2). The taxpayer did not have any right to accelerate or modify the amount of payments, and the insurer was not required to set aside specific assets to secure any part of its obligation. The ruling concluded that the taxpayer did not have actual or constructive receipt, or economic benefit, of the present value of the damages.

Finally, the bill would amend section 162 (deduction for trade or business expenses) to provide expressly that the assignee may deduct the amount of damages paid during the year under that section.

EFFECTIVE DATE

The provisions of the bill would be effective for taxable years ending after 1981.

REVENUE EFFECT

An estimate of the effect of the bill on budget receipts is not available at the time.

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE

This statement is submitted by the American Council of Life Insurance ("ACLI"), a trade association representing 550 life insurance companies which, in the aggregate, account for approximately 96 percent of the life insurance in force in the United States and hold 97 percent of the assets of all United States life insurance companies.

We are pleased to have this opportunity to comment in connection with the recent hearings on H.R. 5470, a bill providing for the tax treatment of "structured annuity" payments—that is, periodic payments of damages on account of personal injuries or sickness. The ACLI is very concerned by the H.R. 5470 provisions that would permit noninsurance companies that provide structured annuities to take a deduction for reserves for future liabilities. We believe that to grant such insurance company treatment to firms that are subject to neither the special subchapter L tax rules nor the rigorous requirements of state regulation is both unwise and inequitable. We urge that the provisions in H.R. 5470 that grant favored treatment to noninsurance company providers of structured annuity payments be eliminated.

DISCUSSION

Structured annuity arrangements are used in cases where it is deemed desirable to provide a seriously injured claimant with an annuity, rather than a lump-sum, damage settlement. In these arrangements the property/casualty company that has primary liability for the damage payments typically assigns an amount to a life insurance company which is then responsible for making the periodic payments to the claimant.

Our concern with H.R. 5470 is addressed to those provisions in the bill that specify the tax treatment given assignees that make periodic payments of damages for personal injuries. Specifically, we are troubled by the provision of the bill which allows such assignees an exclusion from income for amounts received and applied to satisfy assumed damage obligations, yet does not in any way specify when, or how, the assignee must use the amounts received to fund the damage payments. Equally of concern to us is the bill's lack of clarity as to what method would be used to determine the portion of the amounts received by the assignee that will be considered as having been applied to satisfy the periodic damage payments.

In our view, the net effect of H.R. 5470 is to allow noninsurance entities—in totally unregulated fashion—to take a current, reserve-type, deduction for liabilities to be paid in the future. While we recognize the many public policy arguments in favor of providing damage payments to the seriously injured in a lifetime, rather than lump-sum fashion, we can see no justification for giving free rein to entities not subject to the rigorous solvency and reserve accounting standards applicable to insurers to provide such payments. To do so seems especially unwise when one considers that in many cases the structured annuity is the sole source of support for a seriously injured individual. In such a situation there is simply no margin for error and the highest degree of regulatory standards should be applied. In our view, H.R. 5470 falls far short of these standards.

For these reasons, we urge that H.R. 5470 be withdrawn, at least insofar as it specifies the tax treatment to be given third party payors of structured annuity damage amounts.

Special One-Year Rules for Charitable Contributions of Technological Equipment to Primary and Secondary Schools

97TH CONGRESS
2D SESSION

H. R. 5573

To amend the Internal Revenue Code of 1954 to encourage contributions of computers and other sophisticated technological equipment to elementary and secondary schools.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 23, 1982

Mr. STARK (for himself, Mr. EDWARDS of California, Mr. MILLER of California, and Mr. SHANNON) introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To amend the Internal Revenue Code of 1954 to encourage contributions of computers and other sophisticated technological equipment to elementary and secondary schools.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Technology Education Act of 1982".

SEC. 2. CHARITABLE CONTRIBUTIONS OF TECHNOLOGICAL EQUIPMENT TO PRIMARY AND SECONDARY SCHOOLS.

Subsection (e) of section 170 of the Internal Revenue Code of 1954 (relating to certain contributions of ordinary income and capital gain property) is amended by adding at the end thereof the following new paragraph:

"(5) SPECIAL RULE FOR CONTRIBUTIONS OF TECHNOLOGICAL EQUIPMENT TO PRIMARY AND SECONDARY SCHOOLS.—

"(A) LIMIT ON REDUCTION.—In the case of a qualified contribution of technological equipment, the reduction under paragraph (1)(A) shall be no greater than the amount determined under paragraph (3)(B).

"(B) QUALIFIED CONTRIBUTION OF TECHNOLOGICAL EQUIPMENT.—For purposes of this paragraph, the term 'qualified contribution of technological property' means a charitable contribution by a corporation of tangible personal property described in paragraph (1) of section 1221, but only if—

"(i) the contribution is to an educational organization which is described in subsection (b)(1)(A)(ii) of this section and which is not an institution of higher education (as defined in section 3304(f)),

"(ii) the contribution is made—

"(I) not later than 2 years after the date the construction of the property is substantially completed, and

"(II) after the date of the enactment of the Technology Education Act of 1982 and before the date 1 year after such date of enactment,

"(iii) the original use of the property is by the donee,

"(iv) the property is a computer (or other sophisticated technological equipment or apparatus) all of the use of which by the donee is directly in the education of students in the United States,

"(v) the property is not transferred by the donee in exchange for money, other property, or services; and

"(vi) the taxpayer receives from the donee a written statement representing that its use and disposition of the property will be in accordance with the provisions of clauses (iv) and (v).

"(C) INCREASE IN PERCENTAGE LIMITATION.—The limitation of subsection (b)(2) shall be increased by the aggregate amount (determined after the application of this subsection) of the qualified contributions of technological property made by the taxpayer during the taxable year; except that such limitation shall not be increased to an amount greater than 30 percent of the taxpayer's taxable income (as computed for purposes of subsection (b)(2)).

"(D) CORPORATION.—For purposes of this paragraph, the term 'corporation' shall not include—

"(i) an electing small business corporation (as defined in section 1371(b)),

"(ii) a personal holding company (as defined in section 542), and

"(iii) a service organization (as defined in section 414(m)(3))."

SEC. 3. EFFECTIVE DATE.

The amendment made by section 2 shall apply to taxable years ending after the date of the enactment of this Act.

SUMMARY AND DESCRIPTION

PRESENT LAW

General reduction rule

A taxpayer generally may deduct, within certain limitations, the amount of cash or the fair market value of other property contributed to qualified charitable organizations. However, the amount of charitable deduction otherwise allowable for donated property generally must be reduced by the amount of any ordinary income which the donor would have realized had the property been sold for its fair market value at the date of the contribution (Code sec. 170(e)).[1] Thus, a donor of appreciated ordinary-income property (property the sale of which would not give rise to long-term capital gain) generally may deduct only the donor's basis in the property, rather than the fair market value. For example, a manufacturer which donates a product from its inventory generally may deduct only its inventory cost for the item.

Special rules for certain corporate contributions

Under present law, charitable contributions by corporations of two types of ordinary-income property, if donated to certain exempt organizations for specified purposes, are subject to a different reduction rule.

The first exception, enacted in the Tax Reform Act of 1976, is for corporate donations of ordinary-income property to a charitable organization to be used solely for care of the needy, the ill, or infants (such as donations by the producer or manufacturer of food, clothing, or medical equipment), where such use is related to the donee's charitable functions (sec. 170(e)(3)). The second exception, enacted in the Economic Recovery Tax Act of 1981, is for corporate donations of newly manufactured scientific equipment to a college or university to be used for research (or research training) in the United States in the physical or biological sciences (sec. 170(e)(4)).

In the case of a charitable contribution of inventory which qualifies under one of these exceptions, the corporate donor generally is allowed a deduction equal to the sum of its basis in the property plus one-half of the unrealized appreciation (i.e., the difference between fair market value and basis). However, in no event is a deduction allowed for an amount in excess of twice the basis of the property (sec. 170(e)(3)(B)).

These two exceptions were enacted because the Congress concluded that it was desirable to provide a larger tax incentive than would be available if the general reduction rule applied for charitable contributions by corporations of certain ordinary-income property to specified types of charities for particular purposes. At the same time, the Congress also determined that the deduction so allowed should not be such that the donor could be in a better after-tax situation by donating the property than by selling it.

Overall deduction limitation

The total charitable deduction allowed to a corporation is limited to 10 percent of the corporation's taxable income (computed with certain adjustments) for the year in which the contributions are made. (This limitation was raised from five percent by the Economic Recovery Tax Act of 1981.) If the amount contributed exceeds the percentage limitation, the excess may be carried forward and deducted over five succeeding years, subject to the percentage limitation in those years.

ISSUES

1. The first principal issue is whether contributions by a business to schools for use in educating students where there could be a benefit to the donor (e.g., through increasing a market for its products) should be treated for income tax purposes as charitable contributions (in which case a charitable deduction may be allowed for an amount in excess of the cost basis of the donated item), or as noncharitable promotional expenditures (in which case the deduction would be limited to the item's cost to the donor).[2]

---

[1] In the case of donations of tangible capital gain property, the amount taken into account as a charitable contribution must be reduced by a portion of the appreciation if the use of the donated item by the donee charity is unrelated to the charity's exempt functions, or if the property is given to certain types of private foundations.

[2] In *Singer Co.* v. *U.S.*, the U.S. Court of Claims upheld IRS denial of charitable deductions claimed by a manufacturer for the amount of discounts allowed on purchases of sewing machines by schools and colleges (449 F.2d 413) (Ct. Cl. 1971)).

Continued

2. If such contributions are to be treated as charitable contributions, the second principal issue is whether an exception to the general reduction rule applicable to charitable contributions of inventory should be made in the case of qualifying contributions of computers, etc.; i.e., should any deduction in excess of the cost of the goods to the donor be allowed, and if so, how much. Related issues are (a) what kinds of property should be eligible for any special treatment (for example, should all types of sophisticated technological equipment be eligible or only computers, and if so limited, how qualifying computers should be defined); (b) whether any special treatment should be accorded to all taxpayers, or limited (for example) to manufacturers; and (c) whether any special treatment should be limited to taxpayers which actually construct the donated property.

3. The third principal issue is whether, in the case of such contributions, the limitation on the aggregate charitable deduction allowed in one year to a corporation should be increased above the general 10 percent limitation.

EXPLANATION OF THE BILL

Overview

The bill would provide a larger charitable deduction (than would be allowed under the general reduction rule), and would increase the general limitation on the aggregate amount of corporate contributions deductible in a year, for charitable contributions by corporations of computers or other sophisticated technological equipment, if contributed to a primary or secondary school, and if used by the school directly in the education of students. These special charitable deduction provisions would apply only to qualifying donations which are made within one year after enactment of the bill.

The principal intended beneficiary of the bill is Apple Computer, Inc. The provisions of the bill would also benefit any other corporate taxpayer which, during the one-year period following enactment of the bill, makes qualifying charitable contributions of computers or other sophisticated technological equipment.

Requirements for favorable treatment

In order for the special deduction rules of the bill to apply, there must be a charitable contribution (as defined under sec. 170(c)) by a corporation[3] which satisfies the following requirements:

(1) The donated property is a computer or other sophisticated technological equipment or apparatus, and is tangible personal property of an inventory nature (within the meaning of sec. 1221(1));

(2) The property is donated to an educational organization (described in sec. 170(b)(1)(A)(ii)[4] other than an institution of higher education (as defined in sec. 3304(f);[5]

In that case, the court had found that the school discounts were offered "for the predominant purpose of encouraging [the schools] to interest and train young women in the art of machine sewing, thereby enlarging the future potential market by developing prospective purchasers of home sewing machines and, more particularly, Singer machines—the brand on which the future buyers learned to sew." The court concluded that the manufacturer's predominant reason for granting such discounts was other than charitable, notwithstanding that the company said it would have provided the discounts even if it had a total monopoly of the sewing machine market, and even though a company survey showed that fewer than two percent of its regular retail customers had been influenced in buying by previous school training. Since the company expected a return in the nature of future increased sales, the court concluded that the company received a *quid pro quo* for the discounts which was substantial and was therefore inconsistent with allowing charitable deductions.

[3] The bill would not apply in the case of a corporation which is a subchapter S corporation (as defined in sec. 1371(b)); a personal holding company (as defined in sec 542); or a service organization (as defined in sec. 414(m)(3)).

[4] An educational organization is described in sec. 170(b)(1)(A)(ii) "if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, * * *" and includes both public and private schools (Reg. § 1.170A-9(b)(1)).

[5] An institution of higher education, as defined in sec. 3304(f), means an educational institution which (1) admits as regular students only individuals having a certificate of graduation from a high school, or the recognized equivalent of such a certificate; (2) is legally authorized to provide a program of education beyond high school; (3) provides an educational program for which it awards a bachelor's or higher degree, provides a program which is acceptable for full credit toward such a degree, or offers a program of training to prepare students for gainful employment in a recognized occupation; and (4) is a public or other nonprofit institution.

(3) The contribution is made within two years of substantial completion of construction of the property,[6] and within one year after the enactment of the bill;

(4) The original use of the donated property is by the school;

(5) All the use of the donated property by the school is directly in the education of students in the United States;

(6) The donated property is not transferred by the school in exchange for money, other property, or services; and

(7) The donor receives a written statement from the school representing that the use and disposition of the donated property will be in accordance with the last two requirements.

Allowable deduction

If all the conditions are satisfied, the charitable deduction allowed by the bill generally would be for the sum of (1) the taxpayer's basis in the property, plus (2) one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value [7] determined at the time of the contribution and the donor's basis in the property). However, in no event would a deduction be allowed for any amount in excess of twice the basis of the property.

For example, if a manufacturer makes a qualifying contribution to a high school of a computer with a cost basis of $5*X*, and a fair market value of $16*X*, the bill would allow the manufacturer a charitable deduction of $10*X* (twice the $5*X* basis). Assuming a 46 percent tax bracket, the effect of the deduction under the bill would be to reduce the manufacturer's tax liability by $4.6*X*, or 92 percent of the cost of manufacture. The out-of-pocket cost of the donation to the manufacturer, exclusive of distribution and other expenses, would then be $0.4*X*, or 8 percent of the manufacturer's cost. If in the example the fair market value of the computer was $11*X*, the deduction would be $8*X* ($5*X* basis plus ½ of the $6*X* difference between value and basis), and the out-of-pocket cost to the manufacturer would be $1.32*X* ($5*X* cost less $3.68*X* tax benefit).

Increased overall limitation

The bill would provide that the limitation on the aggregate charitable contribution deduction allowed to a corporation (under present law, 10 percent of taxable income, computed with certain adjustments) would be increased by the amount of the taxpayer's qualifying contributions of computers or other sophisticated technological equipment. However, the limit as so increased could not exceed 30 percent of taxable income (as computed with certain adjustments).

EFFECTIVE DATE

The provisions of the bill would apply to taxable years ending after the date of enactment. The special deduction rules provided under the bill would apply only to qualifying contributions which are made within one year after enactment.

REVENUE EFFECT

An estimate of the effect of the bill on budget receipts is not available at this time.

---

[6] Unlike the special deduction rule of present law for qualifying contributions to colleges or universities of scientific research equipment (sec. 170(e)(4)), the rule provided under the bill would not require that the donated computer, etc., is constructed by the donor. For purposes of the present-law rule for scientific research equipment donations, property is to be treated as constructed by the taxpayer only if the cost of parts (other than parts manufactured by the taxpayer or a related person) used in construction do not exceed 50 percent of the taxpayer's basis in the property (sec. 170(e)(4)(C)).

[7] Where donated property is of a type which the taxpayer sells in the course of its business, the fair market value is the price which the taxpayer would have received if the taxpayer had sold the contributed property in the usual market in which it customarily sells, at the time and place of the contribution and, in the case of a contribution of goods in quantity, in the quantity contributed. The usual market of a manufacturer or other producer consists of the wholesalers or other distributors to or through whom it customarily sells, but if it sells only at retail the usual market consists of its retail customers (Reg. § 170A-1(c)(2)).

AMERICAN ASSOCIATION OF SCHOOL ADMINISTRATORS,
OFFICE OF GOVERNMENTAL RELATIONS,
Arlington, Va., June 14, 1982.

Hon. FORTNEY STARK,
Chairman, Select Revenue Measures Subcommittee, U.S. House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR REPRESENTATIVE STARK: The American Association of School Administrators (AASA) representing the nation's school superintendents supports H.R. 5573, the Technology Education Act of 1982.

There is an urgent need to provide educational institutions with the type of technology required for the establishment of computer literacy. The purchase of computer technology is too costly for many local school districts. Financial resources are tightening at state and local levels and without support from the private sector many schools may place computer technology on the fringe rather than essential budget list.

We applaud the private sector and Congress for designing a way to make computer technology available to our nation's schools.

Sincerely,

JOSEPH J. SCHERER,
Associate Executive Director.

STATEMENT OF HON. EDMUND G. BROWN, JR., GOVERNOR, STATE OF CALIFORNIA

We are fortunate to be present at the birth of the Computer Age—a period when each of us will be empowered to control increasing amounts of information. The development of the personal computer now offers unprecedented access to global networks of knowledge inconceivable even today to the average American.

The tax change you are now considering in H.R. 5573, the "Technology Education Act of 1982," will have long-range importance both in terms of America's economic strength and the ability of our citizens to find and hold jobs in an increasingly technological society. The very computers which are causing today's educational system to be increasingly out-of-date can serve as the tools to revolutionize education.

Already, the microcomputer is changing the way we live. It has transformed our economy—high technology industries are expected to produce, directly and indirectly, 40 percent of all new California jobs in the 1980s. The survival of our older industries depends upon their ability to adopt new information technologies like the computer, industrial robots, and sophisticated telecommunications.

The personal computer technologies linked with new telecommunications, is not just a new "tool" speeding up our present way of life, but it is a fundamental change affecting the very patterns of relationships which lie at the basis of society itself.

Microcomputers can accelerate the learning of students and develop creativity in ways not possible in the pre-computer era.

Time Magazine in a recent cover story entitled, "Here Come the Microkids," suggested that "the computer generation is not only. . . propelling traditional education down promising avenues, it is tugging at the entire social fabric, foreshadowing changes at least as startling and momentous as those ushered in by a new generation of automobile users more than a half-century ago."

Most important is the microcomputer's ability to permit interactive learning. By offering instant feedback and a wide range of alternatives, children learn both control and adventure unavailable in traditional texts and drills. Students participate in the learning process, work at their own pace, experiment and make errors while expanding their imagination.

In his trailblazing work, "Mindstorms," Seymour Papert describes how computers will allow young children to actually design and create their won mathematic and scientific programs rather than simply learning by rote.

When 14 year olds find it possible to simulate a detailed computer image of the heart, or the design and operation of a nuclear reactor, they are developing far deeper understandings than the kind of rote memory upon which previous generations relied.

Computer-aided education also affects the key educational variable: motivation. The more a student wants to learn, the more he or she does learn. Computers motivate students to study better because they receive instant feedback as they think and create with the new electronic pencil of the 1980's.

Computers are also a welcome aid to teachers. Computers can free them of repetitious drill and practice tasks, allowing more time for personalized assistance. Teachers also find computers an aid in diagnosing and correcting individual student problems.

Computer education is, of course, very important to prepare students for the new technological workplace. Today's students will often find computer literacy critical to obtaining future employment in hundreds of fields. The Xerox Corporation, for example, has estimated that 90 million Americans will be linked to electronic workstations by 1990 and 36 million will need to be "computer literate." Business Week has estimated that 45 million existing jobs will eventually be made obsolete by new information technologies, most within the next two decades.

One of the major obstacles to the ability of our schools to improve technical education is the expense of purchasing computers. The Technology Education Act of 1982, through the straight-forward extension of the same tax benefits to manufacturers donating computers to elementary and secondary schools as they now receive for donations to universities, provides a low cost way to increase the number of computer in schools, to harness private sector initiative to the benefit of this nation's children, and to prepare today's youth for tomorrow's jobs.

The proper use of computers in the classroom inaugurates a second American educational revolution. The first was our commitment to providing universal, free public education to every American regardless of economic or social status.

This new educational revolution can be a qualitative leap in which we vastly increase the quality of public education and realize the age old dream of empowering each person to reach the limit of his or her ability.

FAIRFAX COUNTY PUBLIC SCHOOLS,
DEPARTMENT OF PLANNING & DEVELOPMENT SERVICES,
Alexandria, Va., June 10, 1982.

Mr. JOHN SALMON,
Chief Counsel, Committee on Ways and Means,
U.S. House of Representatives, Washington, D.C.

DEAR MR. SALMON: I am pleased to have the opportunity to submit testimony on behalf of The Technology Education Act of 1982. As Director of the Resource Development Office of the Fairfax County Public Schools, I want you to know that this school system supports legislation that will enable it to expand existing programs in the computer science and technology fields.

While we have begun to purchase technological equipment for instructional and administrative use, current economic conditions prohibit us from expanding our programs as rapidly as we would like to in order to meet the needs of our school division. The Technology Education Act of 1982 will be of tremendous benefit to school systems across the country.

We, in the Fairfax County Public Schools, are especially grateful for this legislation, and we are pleased to support it.

Sincerely,

JAY D. JACOBS,
Director, Resource Development.

Enclosure.

STATEMENT OF THE FAIRFAX COUNTY PUBLIC SCHOOLS, FAIRFAX, VA.

Mr. Chairman and members of the Select Revenue Measures Subcommittee, as part of its continuing commitment to provide quality educational programs for all of its students, the Fairfax County Public Schools urges passage of H.R. 5573.

As one of the nation's most innovative school divisions, we are interested in acquiring additional computers and other technological equipment for use in our schools. Such acquisitions will enable us to realize our divisionwide priority to emphasize the use of technology to improve instruction.

A stated goal of this division is to develop a systematic plan for the provision of computer-related instructional programs. Passage of H.R. 5573 will facilitate the realization of this goal. Presently, the donation of computers and related technology is restricted to scientific equipment for use on the college level.

We believe that this poses an unnecessary limitation on our ability to provide students with training and instruction in the use of the technological equipment of the future. We firmly believe that this training must be provided for all of our young people.

Our school system has identified local funds for the purchase of microcomputers to expand instructional programs in computer science, business, data processing, and computer literacy. At the present time, we educate approximately 4,000 students in these courses, and this number will continue to increase each year. We are attempting to meet the challenges of our program goals, but the cost of this technology is staggering. Passage of this legislation will help to ease the financial burden imposed by our commitment to train our students in the use of computers and related equipment. Further, we will enjoy the added advantage of having formed an alliance with private sector businesses. In an era of budget cuts and severely limited funds for the expansion of educational programs, we in the Fairfax County Public Schools are confident that you can appreciate the desirability of obtaining such costly items by way of private sector donations.

Because our school system is comprised of over 170 schools and learning centers, it is our hope that at some future date if might be possible to enter into discussions regarding appropriate licensing agreements for computer software. The cost of purchasing multiple software packages for each of our schools is prohibitive to this division. Clearly, computers cannot be used as effectively if only a limited amount of software can be purchased. Provisions must be available for duplication without penalty or additional costs.

H.R. 5573 is an attempt to provide this nation's school divisions with technology that is no longer merely desirable—it is rapidly becoming essential This bill addresses the developing needs of young people. Because we in the Fairfax County Public Schools regard our students as one of this country's most important assets, we urge passage of a bill that is clearly designed to aid in their technological development.

United States Catholic Conference,
Washington, D.C., June 9, 1982.

Re H.R. 5573.—A proposal to encourage contributions of computers and other sophisticated technological equipment to elementary and secondary schools.

Hon. Fortney H. Stark,
Chairman, Subcommittee on Select Revenue Measures, House Ways and Means Committee, U.S. House of Representatives, Washington, D.C.

Dear Mr. Chairman: I am writing on behalf of the United States Catholic Conference, the organization of the Roman Catholic Bishops of the United States, to comment on H.R. 5573, a bill introduced by yourself to encourage the contribution of technological equipment to elementary and secondary schools. The Bishops are responsible for the direct operation of approximately 7,600 elementary and 900 secondary schools. An additional 650 secondary and 500 elementary schools are operated separately by Catholic religious organizations under the authority of the Bishops.

THE PROBLEM

Different treatment is given to Catholic elementary and secondary schools under the provisions of the bill depending upon the organizational structure.

H.R. 5573 would not extend tax benefits on contributions of equipment to Catholic elementary and secondary schools that are organizationally part of a larger entity such as a parish or diocese. The bill would, however, permit tax benefits on contributions to separately organized Catholic schools.

EXPLANATION

This disparate treatment is a result of Section 1.170A-9(b)(1) of the Income Tax Regulations, which provides that the term 'educational organization described in Section 170(b)(1)(A)(ii) of the Internal Revenue Code' does not include organizations engaged in both educational and non-educational activities unless the latter are merely incidental to the educational activities. Thus, where a parish or diocese operates an elementary or secondary school that is not organizationally a separate entity, in most cases its non-educational activities will not be "merely incidental" to its educational activities. This results in denial of favorable tax treatment to contributions of technological equipment made for the use of such schools.

SUGGESTED REMEDY

We propose language for subparagraph 5(E) which is substantially similar to the language contained in Section 4221(d)(5) of the Internal Revenue Code, which defines "non-profit educational organization" for purpose of the exemptions from retailers and manufacturers' excise taxes for fuels and articles sold to a non-profit educational organization for its exclusive use.

PROPOSED AMENDATORY LANGUAGE TO H.R. 5573

Amend subparagraph (5)(B)(i) to read as follows:

"(i) the contribution is to a qualified educational organization which is not an institution of higher education (as defined in Section 3304(f)),

Add a new subparagraph 5(E) to read as follows:

"(E) QUALIFIED EDUCATIONAL ORGANIZATION.—For purposes of this paragraph, the term 'qualified educational organization' means—

"(i) an educational organization which is described in subsection (b)(1)(A)(ii) of this section, or

"(ii) a school operated as an activity of an organization described in Section 501(c)(3) and exempt from income tax under Section 501(a) if such school normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on."

We appreciate the opportunity to express our views on this legislation.

Respectfully submitted,

Rev. Msgr. DANIEL F. HOYE, *General Secretary.*

THE BOARD OF REGENTS,
THE UNIVERSITY OF THE STATE OF NEW YORK,
THE STATE EDUCATION DEPARTMENT,
Rexford, N.Y., July 7, 1982.

Re Support for H.R. 5573 with recommendation to amend.

JOHN SALMON,
Chief Counsel,
Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: As a member of the Steering Committee of the White House Conference on Library and Information Services Task Force (WHCLIST), an elected body charged with responsibility for promoting implementation of resolutions adopted at the 1979 White House Conference on Library and Information Services, I support H.R. 5573, the Technology Education Act of 1983, with an amendment to encourage contributions of computers to public and academic libraries. This amendment to H.R. 5573 would greatly increase access to computer-assisted instruction and other library and learning resources to the largest segment of our population, out of school adults and those enrolled in postsecondary programs. I support with enthusiasm an amended H.R. 5573 and request that this letter be included in the hearing record for the bill.

The attached document, "WHCLIST Report from the States, 1981" [retained in subcommittee files] outlines implementation activities in 57 states and trust territories on resolutions from the 1979 White House Conference on Library and Information Services. A significant number of resolutions support applications of computer technology to improve access and multi-type library resource-sharing.

The National Commission on Library and Information Services (NCLIS) included in its long range program in 1975 the need to strengthen school libraries. H.R. 5573 supports the NCLIS goal of stronger school library media centers. In 1977 NCLIS appointed a task force to delineate the role of school library media programs in networking activities. The task force report noted that school libraries are collectively rich in specialized resources that have value not only for school related users but also for those who use or might use our public, academic and special libraries. Many adults need computer-assisted instruction and high school level materials to prepare for high school diplomas or civil service examinations for employment. Other programs in place in New York libraries, i.e., Homework Hotline and Library-On-Call, could expand services to both students and out-of-school adults by amending H.R. 5573 to encourage contributions of computers to other types of libraries.

An amended H.R. 5573 encouraging contributions of computers to all types of libraries offers an opportunity, equal in importance to the fantastic Federal Rural Electrification Program of the 1930's, to light up the minds of all Americans; and, in so doing, to improve literacy and enhance life-long learning for people of all ages.

Sincerely yours,

LAURA B. CHODOS, *Regent.*

WHITE HOUSE CONFERENCE ON LIBRARY
AND INFORMATION SERVICES TASK FORCE,
June 23, 1982.

Mr. JOHN SALMON,
Chief Counsel, Committee on Ways and Means,
Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: I am writing on behalf of the White House Conference on Library and Information Services Task Force (WHCLIST) regarding H.R. 5573, the Technology Education Act of 1982, and ask that this letter be included in the hearing record for the bill.

WHCLIST, a nationwide organization with representation from each state and territory, encourages implementation of resolutions passed at the White House Conference on Library and Information Services. At that White House Conference and at the 57 state and territorial pre-White House Conferences there was considerable discussion of technological literacy and access to technology. Resolutions were adopted encouraging programs that will make technology and the benefits of technology more widely available to all Americans.

H.R. 5573 would encourage contributions of computers to elementary and secondary schools, assisting students in learning to use and to benefit technology. WHCLIST supports amending H.R. 5573 to encourage contributions of computers to public libraries and to academic libraries. The largest segment of our population is the out-of-school adult for whom the public library is the major provider of materials and services for self-education. Computers in public libraries would allow this large segment of our population to become familiar with the uses and benefits of computers, as well as to learn new skills using the numerous instructional programs available for self-paced educational pursuits. Academic libraries, serving post-secondary education students, also need to make these instructional methods available to their students, many of whom missed by only a few years the opportunities to use computers in elementary and secondary schools.

I urge you to amend H.R. 5573 so that contributions of computers to public and academic libraries are encouraged.

Sincerely yours,

WILLIAM G. ASP,
Acting Chair.

MISCELLANEOUS TAX LEGISLATION

MONDAY, JULY 12, 1982

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, D.C.

The subcommittee met at 10:15 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Fortney H. (Pete) Stark (chairman of the subcommittee) presiding.

Chairman Stark. The Subcommittee on Select Revenue Measures will begin its hearing on miscellaneous bills.

This morning we will receive testimony on five bills. These bills affect limited groups of taxpayers. It is part of the function of this subcommittee to provide a forum for such groups to seek fair and equitable treatment under our tax laws.

We will proceed in the usual manner, hearing first from Treasury on all these bills and then receive testimony on the bills scheduled for today in numerical order.

I would remind witnesses, with the exception of the Treasury, who has several bills to cover, that they should summarize their statements and limit their oral testimony to 5 minutes. This is because we have received the written statements in advance, which will be included in the hearing record in their entirety.

Without objection, the record will remain open for sufficient time for additional written comments and questions for the witnesses, and without objection, the press release announcing today's hearing will be incorporated into the hearing record.

[The press release announcing the hearing follows:]

[Press Release of Friday, June 25, 1982]

HON. FORTNEY H. (PETE) STARK, CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, ANNOUNCES A PUBLIC HEARING ON MISCELLANEOUS TAX BILLS TO BE HELD ON MONDAY, JULY 12, 1982

The Honorable Fortney H. (Pete) Stark (D., Calif.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. Home of Representatives, announces a one-day public hearing on miscellaneous tax bills to be conducted on Monday, July 12, 1982, at 10:00 a.m. in 1100 Longworth House Office Building, the Committee's main hearing room.

The lead-off witness is expected to be the Honorable John E. Chapoton, Assistant Secretary for Tax Policy, Department of the Treasury.

Testimony is invited on the following bills:

1. H.R. 617—(Messrs. Rousselot, and Lewis)—To amend the Internal Revenue Code of 1954 to provide for a definition of the term "artificial bait".

2. H.R. 2402—(Messrs. Jones of Oklahoma, Hagedorn, Pickle, and Vander Jagt)—To amend the I.R.C. of 1954 to change the period for the payment of taxes under section 4161(a) of such code.

3. H.R. 4917—(Mr. Rangel)—To amend the I.R.C. of 1954 to clarify the local furnishing rule with respect to the tax-exempt status of interest on obligations issued to provide facilities for the local furnishing of gas.

4. H.R. 5985—(Messrs. de Lugo, Holland, Heftel, and Schulze)—To amend the I.R.C. of 1954 to reduce the rate of certain taxes paid to the Virgin Islands on Virgin Islands source income, to provide that the foreign tax credit shall be applied separately with respect to taxes paid or deemed paid to the Virgin Islands, and for other purposes.

5. H.R. 6218—(Mr. Duncan)—To amend the I.R.C. of 1954 relative to insurance organizations for veterans.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentation will be limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for Committee members to interrogate witnesses. The witnesses will be grouped as panels to expedite the hearing, and strict time limitations will be established for each panelist.

The following is an outline of the procedure to be followed by organizations and individuals who either may want to appear and testify during this hearing or file a written statement for the printed record of the proceedings. All requests should contain the following information:

1. The name of the witness, his title, address, firm affiliation and/or organization he will represent (as well as a telephone number where he or his designated representative may be reached).
2. If appearing in an individual capacity, a list of any clients at whose request or in whose employ the witness appears.
3. A topical outline or summary of comments and recommendations.

Requests to be heard must be made by telephone to Ms. Harriett Lawler [telephone (202) 225-3627] by the close of business, Wednesday, July 6, 1982. The telephone request should be followed by a formal written request addressed to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, witnesses scheduled to appear before the Subcommittee should comply with the following rules:

1. All witnesses must submit 75 copies of their prepared statement to the full Committee office, Room 1102 Longworth House Office Building, not later than noon Friday, July 9, 1982.
2. Witnesses should not read their written statements to the Subcommittee, but should instead limit their oral presentations to a summary of the points included in the statement.
3. Not more than five minutes will be allowed for the oral summary.

Failure to comply with these requirements may result in the witnesses being denied the opportunity to testify in person or being deferred until all other testimony is heard.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, five copies are required and must be received by the close of business, Monday, July 26, 1982. The statements should be delivered to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office during the course of the hearing.

Chairman **Stark**. Any witnesses who find that 5 minutes severely limits them, may inquire of the Chair to have additional time at the conclusion of the witness list.

I would like to welcome Hon. John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy. You may proceed.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Thank you, Mr. Chairman.

I have a lengthy statement and I will attempt to summarize going through each of the five bills before you to the extent I can.

H.R. 617 AND H.R. 2402

The first, H.R. 617 and 2402, Mr. Chairman, deal with excise tax on fishing tackle and equipment. Present law imposes a 10-percent excise tax on fishing rods, reels, and the like, and on artificial lures, baits and flies.

The amount of the tax collected in the previous year is appropriated each year to the States through a program administered by the Department of Interior.

The program is designed to promote recreational fisheries, and the theory underlying the tax is that the cost of the program should be borne by the primary beneficiaries, sports fishermen and the industry in general.

The Federal Government bears the cost of collecting the tax and distributing the funds to the States, although this cost is offset partially by the float benefit, the time between the collection of the tax by the Treasury and its distribution to the States.

H.R. 617 deals with the definition of artificial lures, baits and flies. The regulations say that the term includes edible materials that have been processed to resemble an edible article that is attractive to fish.

But the Court of Claims in the *Nelson Ricks Creamery* case disagreed with that regulation definition and said that the artificial bait did not include a certain cheese product packaged and sold as fish bait which is edible by fish and by humans.

The bill would go along with the *Nelson* case and say that artificial bait does not include any substance which contains 85 percent or more by weight of plant or animal material which can be ingested by fish.

The Treasury Department opposes H.R. 617. The definition of "artificial" in the current regulations has the advantage, we think, of treating all manufacturers of bait equally.

The fact that the product may also be edible does not override the fact that it is manufactured. The fact is that manufacturers advertise the superiority of the bait after it has been processed by them.

When you keep in mind that the policy of the tax is to place the cost of State fishery programs on the primary beneficiaries through taxing the equipment used in fishing, then it seems only fair to impose the tax without regard to whether the processed bait may otherwise be edible.

H.R. 2402 would postpone the time for payment of the tax. Under current law, all excise taxes must be paid 9 days after the close of the period involved if the total tax liability exceeds $2,000.

H.R. 2402 would amend this to postpone the time for payment of the excise tax on fishing tackle and equipment until the last week of the succeeding quarter in the case of the first three quarters of the taxable year.

We oppose delaying the payment of the tax. It is made the basis for delay that the sale of equipment is seasonal in nature and that long credit terms are often given to purchasers by manufacturers who thus end up paying the tax before they collect payment for the sale of the item from the purchasers.

That is true in a lot of other instances where excise taxes are imposed before actual payment is made. The credit extended by an industry is an industry-by-industry matter and we cannot vary the time for payment based upon the credit practices of a particular industry.

Chairman **Stark**. Mr. Secretary, in dealing with this question, it has been suggested that this excise tax on fishing tackle and equipment was self-imposed. Also this was an idea which the industry came up with in order to raise money for wildlife and game preserves. This idea is different from all our other excise taxes except those which may have been self-imposed for certain ammunition and so forth that comes under the same rule.

Is that generally correct?

Mr. **Chapoton**. I think the imposition of the tax certainly was supported by the industry. I think a lot of user-type fees have received more or less qualified support from various segments of industry, including highway excise taxes, and such.

But I think it probably would be fair to say this was closer to being self-imposed than most. Obviously some people want out, as with the artificial bait.

Mr. **Duncan**. If you would yield, the tax doesn't go into a special fund for the sports, but to the general fund, doesn't it?

Mr. **Chapoton**. The tax is turned over to the States, the full amount of the tax is turned over from the Treasury into the State fishery programs.

Mr. **Duncan**. How much revenue loss would be involved here?

Mr. **Chapoton**. I don't have a figure.

Mr. **Duncan**. Very little, wouldn't it be?

Mr. **Chapoton**. The entire tax is very little on the Federal scale.

Mr. **Duncan**. This would be very small, wouldn't it? If the whole amount of tax is small, then portions of it would be small.

Mr. **Chapoton**. It would be very small. I think the question is whether you can distinguish this—whether we are doing it for the terms of the industry or whether we are doing it because it is in effect a self-imposed tax, as the chairman states, and therefore they should pay the self-imposed tax when they wish.

Chairman **Stark**. The Chair is looking for a way out.

Mr. **Chapoton**. But keep in mind the Federal Government carries the cost of administering the tax. If you decrease the time that the Federal Government has the money, you decrease that advantage to the Federal Government.

Chairman **Stark**. The argument has been posed, that in a sense of equity, we have many bills that postpone the length of time for payment of the excise tax. As interest rates get higher, we have more and more people waiting until after the excise tax, in order to save cashflow.

The question comes, if we are willing to extend the time for this industry, how come we are not willing to do the same for a half dozen others? The response is that this is a self-imposed excise tax, therefore it ought to be considered separately from most of the others.

I am hearing the Secretary say that indeed the road tax was more or less self-imposed by the trucking industry to build highways.

In that sense, I think——

Mr. CHAPOTON. I want to be careful on that, as a bit of an overstatement. It is correct that a lot of industries would like, would not oppose and in some cases, would—I think the trucking industry may be one—would like to have the tax, provided the funds were spent the way they would like them to be, and if you have a trust fund, that would be the case.

We have to be careful when we treat any excise tax differently as far as collection is concerned.

Chairman STARK. Thank you.

H.R. 4917

Mr. CHAPOTON. The next bill is H.R. 4917, which deals with the question of tax-exempt financing of facilities for the local furnishing of gas in the New York City area.

Interest paid to holders of industrial development bonds, the proceeds of which are used by private business, generally is not exempt from Federal income tax.

There are numerous exceptions to that rule, one of which allows tax-exempt IDB's to be used to finance facilities for local furnishing of electric energy or gas.

Before 1978, the Treasury Department defined facilities for "local furnishing" as facilities which supply energy or gas to one or more communities or municipalities but in no event more than two contiguous counties or their political equivalent.

In 1978, legislation was enacted to expand this definition in the case of electric energy facilities so that the facilities could furnish electric energy to an area consisting of a city and one contiguous county, even though the area covers more than two counties.

The primary beneficiary of this was New York City, which consists of five boroughs, and the legislation would cover New York City and any contiguous county.

The 1978 legislation applied only to facilities for the furnishing of electric energy and did not expand the definition for local furnishing of gas. Therefore, there is a difference in treatment of gas facilities and electric generating facilities.

In our statement, we point out that we have serious concerns about the great growth in private-purpose, tax-exempt financing. The total volume of private-purpose bonds in 1976 was only $8.5 billion, representing 25 percent of the total long-term, tax-exempt market. That volume has grown to 48 percent of the tax-exempt market in 1981, and there will be $35 billion of tax-exempt, private-purpose taxes and bonds outstanding in 1982. New issues will consume 55 percent of the entire long-term, tax-exempt market.

We have made a proposal which would significantly restrict the use of private-purpose, tax-exempt bonds. Our proposal will be considered by the Congress this summer.

We hope that some meaningful restrictions will be adopted by the Congress.

In connection with the specific question presented by this bill, we do think there is an unfair distinction between furnishing of electric energy and furnishing of gas. Therefore, we have taken the position that if meaningful restrictions are imposed on the use of private-purpose, tax-exempt bonds, we would not oppose a change which straightens out the irrational distinction between electric-energy facilities and facilities for the furnishing of gas.

As an isolated matter, we would oppose this bill, however.

H.R. 5985

H.R. 5985 deals with the very complicated subject of taxes paid to the Virgin Islands. It is important that our position on this legislation be considered in the context of the entire treatment of taxes by the Virgin Islands and their relationship to taxes imposed on Virgin Islands residents investing in the United States.

In my written statement, I briefly outline the Virgin Islands' so-called mirror code system of taxation and I describe the interpretation of the mirror code, its application and some of the problems that tax administrators and taxpayers, attempting to use that code, face.

Since 1922, the income tax laws of the United States have been in force as the territorial income tax of the Virgin Islands. Congress established this system in a one-sentence rider to the Naval Appropriations Act of 1922. Administrative and judicial interpretations have read that act as requiring the Internal Revenue Code to be adapted for application in the Virgin Islands by substituting the name Virgin Islands for the name United States, and vice versa, where appropriate to give the law proper effect.

This is the so-called Virgin Islands mirror code.

It is extremely complex and gives a great deal of uncertainty to investors and to the tax administrators alike.

The principal consequence of the mirror code is that U.S. individuals and corporations that are not inhabitants of the Virgin Islands are considered nonresident aliens and foreign corporations of the VI and, therefore, are subject to the Internal Revenue Code treatment of nonresident aliens for investment income and business income in the Virgin Islands.

Chairman STARK. Mr. Secretary, does that complete that portion?

Mr. CHAPOTON. No.

Chairman STARK. When you are done with the Virgin Islands, I have an issue I want to bring up.

Mr. CHAPOTON. Yes, Mr. Chairman. My point is that U.S. persons investing in the VI are subject to a 30-percent withholding tax on their investment income from the VI.

Also, nonresident foreign persons, not U.S. persons, investing in the VI are also subject to a 30-percent withholding tax on investment income earned from their investment in the VI.

I think it is important, that we understand the complexity this system causes for the VI and for investors. The Treasury Department has done a great deal of work in looking at the possibility of legislative reform to right these complexities and to make the tax treatment of the VI more certain and more within the VI's own control. We are very reluctant to agree to temporary changes until a longer-range solution is found.

This bill would do basically two things. It would reduce from 30- to 10 percent the rate of VI withholding on fixed and determinable income that is, investment income basically, from sources within the VI.

A U.S. person or non-U.S., non-VI person investing in the VI would have withholding reduced from 30 to 10 percent.

Second, the bill adds a new section to the Internal Revenue Code which would allow a U.S. citizen an expanded foreign tax credit for VI taxes imposed on his investment in the VI.

The position we have taken on this legislation, Mr. Chairman, is that we would oppose a reduction in the withholding rate on foreign investment in the VI because that would allow the VI to be used as a conduit for investment through the VI to the United States and avoid entirely withholding taxes in investment in the United States. Therefore, we do oppose the reduction in withholding rate on foreign investment.

As an interim matter, we will not oppose a reduction in the withholding rate on U.S. investment in the VI, because we do think there is a serious problem causing deferral of investment in the VI until a permanent solution to the overall problem can be realized.

We also oppose enlarging the foreign tax credit, in effect removing the limits on the foreign tax credit against U.S. tax liability for VI taxes paid because, in effect, that would allow credits to be claimed against U.S. source income, not just VI income, and we think would be an undesirable extension of the limit on the foreign tax credit with respect to VI taxes.

In summary, we opposed the legislation itself, but as an interim measure support a reduction in the VI taxes on payments of VI source-fixed or determinable income to U.S. persons.

Mr. Chairman, that concludes my testimony on the VI situation.

Chairman **Stark**. On the Virgin Islands issue, I would appreciate it if you would research it for me and see if you have a position.

In sections 934 and 936 of the code, there is a provision that relates to Puerto Rico. It has caused some problems for some manufacturers who are concerned that income earned in Puerto Rico would have to be received in the Island. The word "received" is the key.

Evidently it has been interpreted to mean, for example, if I purchase a widget from a U.S. company that manufactures in Puerto Rico and mailed the check to Puerto Rico and that check is endorsed and subsequently mailed back and deposited in the United States, that is considered as received in Puerto Rico.

If, on the other hand, I purchase the widget from a sales agent and it is deposited in a bank in the United States for credit to an account in Puerto Rico, that is not considered to be received in Puerto Rico.

With modern banking transactions and cash collections being what they are, this has become of great concern. People are concerned that it is a vestigial requirement in the code which could be changed.

I really wouldn't expect you to comment on it at the moment. But it has come up in questions and I would appreciate if you would, for the record, research that for us.

Mr. CHAPOTON. All right. I am informed it was changed for 934 corporations but not for the 936 companies which are, of course, companies operating in Puerto Rico. I have not personally heard of this problem. We have spent a lot of time in the last 8 months on section 936.

Chairman STARK. It is a technical issue which has generated several questions pertaining to the policy effects of having people manufacture in Puerto Rico.

Mr. CHAPOTON. We will be happy to look at it. As you may know, the Senate bill, which the Senate Finance Committee just dealt with, does have a provision dealing with 936.

Chairman STARK. There is not one here but I would be interested in your position on that.

H.R. 6218

Mr. CHAPOTON. The final bill before you, Mr. Chairman, is H.R. 6218, which deals with exemption for insurance organizations for veterans. H.R. 6218 would create a new category of tax exemption for organizations formed prior to 1880 which provide insurance benefits to past or present members of the Armed Forces or their spouses and dependents. To understand this, a little history of the tax treatment of war veterans associations is required.

Prior to the enactment in 1972 of 501(c)(19), a section that grants tax exemption to organizations at least 75 percent composed of war veterans, most veterans, organizations qualified for exemptions as either social welfare organizations under 501(c)(4), or in some cases as social clubs.

Before the enactment of the Tax Reform Act of 1969, there was no tax on insurance activities of veterans organizations since the unrelated business income tax did not apply to social welfare organizations and did not apply to social clubs.

The 1969 act extended the unrelated business income tax to virtually all exempt organizations, including those two, but it did not cover 501(c)(9) organizations and, therefore, these voluntary employees beneficiary associations are carrying on insurance activities free of tax under section 512.

In 1972, Congress recognized the fact that all veterans organizations were potentially subject to the unrelated business income tax on their insurance activities and then adopted 501(c)(19) together with an amendment to section 512 which defines unrelated business income, to provide treatment similar to the 501(c)(9) treatment, that is exemption from tax on their insurance income.

The new exempt category, 501(c)(19), was enacted retroactive to 1969 but does not apply to all veterans organizations.

These veterans organizations under (c)(19) can have a broad range of purposes including promotion of community welfare, assistance of disabled and needy war veterans, and a broad range of other activities, including provision of insurance benefits. They are exempt, as I mentioned, from unrelated business income tax on any payments attributable to life, sickness, accident or health insurance coverage with respect to members or their dependents, to the extent the income is set aside either for the purpose of providing for the payment of insurance benefits or for a qualified charitable purpose specified in section 170(c)(4).

This exemption is also subject to the caveat that no part of the net earnings of these organizations may inure to the benefit of any member or other individual.

There are now two problems faced by veterans organizations that conduct insurance activities. First, many of the organizations that have qualified under (c)(19) are now having difficulty meeting the requirements that 75 percent of their membership be made of war veterans because of the prolonged period of peace and the natural attrition rate since the last war of the United States.

Various proposals have been made to remove the requirement that the veterans be war veterans. We have in the past opposed those changes because in view of the preferential treatment received by these organizations as compared to other social welfare organizations and as compared to insurance companies, we have thought it not wise to greatly broaden the membership requirements of war veterans associations.

The second problem these organizations now face is that they have recently been questioned by the IRS as to whether their insurance activities, particularly the use of whole life insurance, might result in inurement to individuals and therefore result in violation of the specific requirements of both (c)(19) and (c)(9), that is that they qualify for exemption only if the offering of a whole life insurance is not deemed inurement to the benefit of a member.

H.R. 6218 would solve both of these problems by creating an entirely new category of exemption under a new (c)(23) section for any organization which is organized prior to 1880 and is composed of more than 75 percent of past and present members of the Armed Forces or spouses or dependents of the like.

We understand that the bill would benefit primarily the Army Mutual Aid Association and the Navy Mutual Aid Association.

We are opposing H.R. 6218 for several reasons, Mr. Chairman. First, by permitting both nonwar veterans and veterans' spouses and dependents to be counted within the 75 percent membership limitation, the bill would significantly broaden the membership of organizations, that can operate as tax exempt insurance companies or agencies.

It may be possible to justify the present law exemption from unrelated business income tax under (c)(19) on the grounds that this exemption is limited to organizations of persons who have been in combat service of this country but we don't think this generous statutory scheme should be extended to all persons who have been members of the Armed Forces at any time and their spouses and dependents.

We would not oppose a broadening of the membership requirements if the organizations were to be subjected to income tax as unrelated business income on the net income from insurance activities, however.

Mr. DUNCAN. Would you yield?

Mr. CHAPOTON. Yes, sir.

Mr. **Duncan**. You actually are not doing this for all the veterans' organizations. You state some good reasons why their problem should be taken care of. You are only talking about one or two small veterans organizations, organized prior to 1880. But then your testimony covers all veterans organizations.

You address problems which this bill isn't related to at all.

Mr. **Chapoton**. Well, they are not small. They are very large organizations, Mr. Duncan. One of them, the second objection I was going to specify is we do not see a distinction between these two veterans organizations and others.

I think the question is we have a hodgepodge of rules in the 501(c) area now dealing with tax exempt organizations that can provide insurance to their members, and not be taxed on their insurance business.

We are seeing several attempts, this being one, to enlarge their membership generally. We don't have any problem with that. But we have a great deal of difficulty with broadening the category of organizations that can qualify and carry on a tax exempt insurance business. That is the question we have to address.

Mr. **Duncan**. Group insurance with most organizations—the bar association which I belong to—do they provide for payments to be part of the group? Is that common in most organizations?

Mr. **Chapoton**. That is correct, but the profit to the organization——

Mr. **Duncan**. Why shouldn't some dependent or widow of some veterans, especially the older veterans, be included in the group? They go through a war, too.

Mr. **Chapoton**. Of course one of the points is to remove the requirement that they have been at war, there is no problem with furnishing insurance, the question is whether we are going to have a huge category of tax exempt income from the carrying on of the insurance business.

We just have to worry about the distinction between these and other insurance operations.

Chairman **Stark**. Does the bar association have to pay tax if they have income from insurance operations?

Mr. **Chapoton**. Yes, unrelated business income would include that.

Chairman **Stark**. If in fact these organizations operated under 501(c)(4) and kept the premiums low enough or paid dividends back to their shareholders they could operate them so as to show no profit, couldn't they?

Mr. **Chapoton**. They could operate certainly to reduce the cost to the members and therefore reduce their profits but I am sure that they are using these funds for other purposes. To impose tax on this it would take funds out of their hands. It would probably not be possible to make no profit on the insurance operation.

We have not looked at it that closely. We are trying to get more facts on the size of the insurance business of these organizations.

I am handed this morning the annual report for the year ended December 31, 1981, from the Army Mutual Aid Association and for that period they show premium income of $7,700,000, and net investment income of $14,700,000.

Mr. **Duncan**. Do they show a payout?

Mr. CHAPOTON. Benefits and expenses, $5.5 million in death benefits; additions to policy reserves $7 million; operating expenses $2 million, and other miscellaneous items for a net payment of benefits and expenses of $15,300,000.

Mr. DUNCAN. In other words, they lost $7 million.

Mr. CHAPOTON. No. Gains from operations and retaining for contingencies is $7 million.

Chairman STARK. A $7 million profit.

Mr. DUNCAN. Total income is $7 million.

Mr. CHAPOTON. That includes investment income as well.

Chairman STARK. I believe the income is $7 million from operations and $14 million from investments for a total of $21 or $22 million.

Mr. CHAPOTON. $22 million.

Chairman STARK. So there was a $7 million profit on which they paid no tax.

Mr. CHAPOTON. They would pay no tax on the $7 million profit. I am reading these for the first time, I want to be careful about going through this.

Chairman STARK. On the Virgin Islands, it is my understanding that—let me try this two ways.

Is your principal objection the nontax treaty part? In other words, if the bill were changed so that the reduction were only available to treaty partners, does that reduce your objection or eliminate it?

Mr. CHAPOTON. We have tried to see if that is workable. Thus far we have not come up with a solution that would be satisfactory on that. We would not mind continuing to look at that.

Chairman STARK. It is my understanding that you are supporting legislation which would eliminate the 30 percent withholding entirely.

Mr. CHAPOTON. That is correct.

Chairman STARK. At that point you would have no objection to an elimination.

Mr. CHAPOTON. At that point, that is correct.

Chairman STARK. So it is fair to say your objection is focused on this treaty question. You would just as soon oppose the withholding altogether, right?

Mr. CHAPOTON. Yes, we would support legislation to do away with withholding altogether on—well, for the portfolio interest, not on dividends, Mr. Chairman.

Chairman STARK. I see.

Mr. CHAPOTON. But things change dramatically if that legislation is passed. Even beyond that, Mr. Chairman, I think all parties who look at this agree that we need a more permanent fix to the mirror code. It simply does not work correctly.

You are correct in the objection to—our objection to lowering withholding on foreign investment into the V.I., that is our problem, that the V.I. would be used as a conduit to avoid our withholding tax. As long as we have a withholding tax we don't want to set up conduits through which it can be avoided.

Chairman STARK. You are not convinced that just making this a benefit available only to treaty countries——

Mr. **Chapoton**. That is very difficult to do. We have looked at that in other contexts and we are looking at it in the V.I. contexts. I don't want to say it is impossible to do but you are using other treaties through a conduit in effect.

Chairman **Stark**. Do you have any questions, Mr. Duncan?

Mr. **Duncan**. I have no further questions.

Chairman **Stark**. I appreciate your taking the time to come and testify this morning.

Mr. Secretary, those are the only questions, the one on where income received, for you to respond and we will add your response.

Mr. **Chapoton**. For section 936; yes, sir.

Chairman **Stark**. We thank you for taking time to be here.

Mr. **Chapoton**. Thank you very much.

[The prepared statement follows:]

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Treasury Department on the following tax bills: H.R. 617 and H.R. 2402, both of which deal with the excise tax on fishing tackle and equipment; H.R. 4917, which would expand the provision of the Internal Revenue Code permitting tax exempt financing for facilities for the local furnishing of gas; H.R. 5985, relating to taxes paid to the Virgin Islands; and H.R. 6218, which would provide tax exempt status to certain insurance organizations for veterans.

I will discuss each of the bills in turn.

---

*Time considerations have not permitted the Office of Management and Budget to advise on the relationship of this statement to the program of the President.

H.R. 617 and H.R. 2402
Excise Tax on Fishing Tackle and Equipment

Background

Section 4161(a) of the Code imposes a manufacturers excise tax at the rate of 10 percent on the sales price of fishing rods, creels, reels, and artificial lures, baits and flies. Amounts equivalent to the prior year's excise tax receipts are appropriated each year to the States through a program administered by the Department of the Interior to reimburse the States for part of the costs they incur in connection with programs to promote recreational fisheries. The theory underlying the tax is that the cost of these programs should be borne by their primary beneficiaries, sport fishermen and the sportfishing industry. The Federal government bears the cost of collecting the tax and distributing the funds to the States, although this cost is partially offset by the benefit to the Treasury of the use of the funds between the time of their collection and distribution.

H.R. 617 -- Definition of Artificial Bait

Among the items subject to the 10 percent tax on sales of fishing equipment are "artificial lures, baits, and flies." In interpreting this provision, the Treasury regulations state that "the term includes . . . edible materials that have been processed so as to resemble a different edible article considered more attractive to fish, such as bread crumbs treated so as to simulate salmon eggs, and pork rind cut and dyed to resemble frogs, eels, or tadpoles." The Internal Revenue Service has held in rulings that the tax applies to bait manufactured from gelatin or marshmallows (Rev. Rul. 71-321) and bait made from cheese (Rev. Rul. 77-302). However, the Court of Claims held in Nelson-Ricks Creamery Company v. United States, 634 F.2d 566 (Ct. Cl. 1980), that the term "artificial bait" did not include a certain cheese product packaged and sold as fish bait which is edible by humans and fish.

H.R. 617 would amend the Code to provide that "artificial bait" shall not include any substance which contains 85 percent or more by weight of plant or animal material which can be ingested by fish.

The major argument advanced by the taxpayer in the Nelson-Ricks Creamery Company case and by the proponents of this bill is that bait made from edible plant and animal products is not "artificial." We do not believe the result reached by the Court of Claims in that case is compelled by a fair reading of section 4161(a), and we do not consider H.R. 617 a desirable amendment to the Code.

We believe that the Internal Revenue Service's definition of what is "artificial" for purposes of section 4161(a) is reasonable and has the advantage of treating all manufacturers of bait equally. Under this definition, animal or vegetable products which are dyed, scented, shaped, or otherwise processed to be sold as bait would be considered artificial -- made or contrived by man as opposed to nature -- and therefore would be subject to the tax. The fact that the products are edible does not override the fact that they are manufactured. Indeed, the products in question are promoted as being superior to natural products. The qualities which the processing has added to the original natural substance are advertised as uniquely advantageous in the catching of fish.

Since the policy underlying the tax is to place the cost of State fisheries programs on their primary beneficiaries through taxing equipment used in sportfishing, theoretically all bait should be subject to the tax to avoid discrimination against particular items. However, since the tax imposed by section 4161(a) is collected from manufacturers and importers it cannot feasibly be extended to natural items such as worms, minnows, and crickets. On the other hand, it is completely consistent with the theory and purpose of the tax to impose it on all manufactured items that are identifiable as bait at the time of their sale by the manufacturer.

Current law follows the logical path of taxing all artificial lures, baits and flies, all of which are designed for the catching of fish. H.R. 617, by exempting from the tax certain types of bait manufactured from edible material, would give those who manufacture bait from edible material a competitive advantage over those who manufacture bait (as well as lures and flies) from other materials. We question the fairness of this result.

H.R. 2402 -- Postponing Time for Tax Payments

Section 6302 of the Code provides that all manufacturers excise taxes must be deposited by the manufacturer on a semi-monthly basis nine days after the close of the period involved if total tax liability exceeds $2,000 for any month in the preceeding calendar quarter. H.R. 2402 would amend section 6302 to postpone the time for payment of the excise tax on fishing tackle and equipment imposed by section 4161(a). Under this bill, the tax would be due and payable as follows:

1. in the case of articles sold during the calendar quarter ending December 31, on March 31;
2. in the case of articles sold during the quarter ending March 31, on June 30;

3. in the case of articles sold during the quarter ending June 30, on September 24; and

4. in the case of articles sold during the quarter ending September 30, at such time as the Secretary may prescribe by regulations.

Treasury is opposed to H.R. 2402. The argument advanced for extending the time for payment of the excise tax on fishing equipment is that the seasonal retail sale pattern for sport fishing equipment leads manufacturers to grant lengthy credit terms to distributors, so that the latter will increase stock during the off-season and enable the manufacturers to produce at a more even pace. Under present regulations, the manufacturers must pay the excise tax before they receive payment from their distributors. However, the extended credit terms of the manufacturers also require the manufacturers to finance all other expenses (rent, wages, raw materials, etc.) for some time before receiving payment from their distributors. Thus, H.R. 2402 could have the effect of delaying the payment of the excise tax on an item until after the manufacturer has paid all other expenses relating to the item. Different trades have different customary credit terms, which are designed to facilitate operations and maximize profits. Treasury sees no reason why the time of payment of manufacturers excise taxes should be varied for different industries depending on the usual credit terms in the industry. If a special rule is fashioned for fishing equipment, other special rules may have to be given every other industry which has unique business practices. Passage of this bill will open the way to others seeking specialized relief.

As I have indicated previously, the Federal government bears the cost of administering and enforcing the fishing equipment excise tax, a tax that is imposed and administered for the primary benefit of sport fishermen and the sport fishing industry. H.R. 2402 would delay collections of tax liabilities accrued during each of the first three fiscal year quarters until the last week of each succeeding quarter. During this time, the manufacturers of fishing equipment and not the Treasury would have the use of the funds. This reduction in current receipts would require Treasury to borrow additional amounts for the general fund to maintain authorized levels of government spending.

H.R. 4917

Tax Exemption for Industrial Development Bonds for Facilities for the Local Furnishing of Gas

Under present law, interest on State and local government obligations classified as industrial development bonds (IDBs) generally is not exempt from Federal income tax.

However, present law provides numerous exceptions to this general rule. One such exception (I.R.C. section 103(b)(4)(E)) allows tax-exempt IDBs to be used to finance facilities for "local furnishing" of electric energy or gas.

Before 1978, Treasury regulations defined "local furnishing" as providing service to the general populace of one or more communities or municipalities, but in no event more than two contiguous counties (or their political equivalent). In 1978, legislation was enacted to expand the definition of "local furnishing" of electric energy to include furnishing solely within an area consisting of a city and one contiguous county, even though the area covers more than two counties. The primary purpose of the 1978 legislation was to allow use of tax-exempt financing of electric facilities for New York City (which consists of 5 boroughs) and for any county contiguous to New York City. However, the 1978 legislation did not similarly expand the definition of "local furnishing" of gas.

H.R. 4917 would amend section 103(b)(4) to provide that the term "local furnishing" of gas includes furnishing gas solely within an area consisting of a city and one contiguous county. This is the same rule which applies in the case of a facility for "local furnishing" of electricity, and would permit tax-exempt financing of facilities used for furnishing gas to New York City and a contiguous county.

In general, the Treasury Department opposes changes in the law to expand the use of tax-exempt financing for private activities. There has been a tremendous increase in recent years in the volume of tax-exempt bonds issued for a wide variety of private activities such as housing, student loans, and private hospitals and educational institutions, as well as for industrial development. In 1976, the volume of private purpose bonds was about $8.5 billion, or about 25 percent of the long-term tax-exempt bond market. The volume of private purpose bonds rose to more than $25 billion in 1981, representing 48 percent of the tax-exempt bond market. The Treasury Department estimates that over $35 billion of private purpose bonds will be issued in 1982, consuming over 55 percent of the entire long-term tax-exempt bond market.

The proliferation of private purpose bonds has contributed to a significant narrowing of the difference in interest rates between tax-exempt and taxable bonds. While the tax-exempt rate historically has been about 65 to 75 percent of the taxable rate, tax-exempt bonds are now generally yielding about 80 to 85 percent of the taxable rate. This erosion of the relative advantage of tax-exempt financing has made it more costly for State and local governments to finance essential public projects such as schools, roads and prisons. It has made tax-exempt financing even less cost effective as a subsidy for private activities, since more of the benefit is siphoned off for bond investors as tax-exempt rates grow closer to taxable rates. The increasing volume of private purpose bonds has also caused mounting Federal revenue losses. The Treasury Department estimates that the total Federal revenue loss from private purpose tax-exempt bonds outstanding in fiscal year 1981 was $3.2 billion and will be $4.2 billion for private purpose obligations outstanding in fiscal year 1982. These revenue losses will increase significantly in future years unless additional limitations are imposed.

These and other considerations have caused us to conclude that meaningful additional restrictions are needed to reduce the growth of private purpose tax-exempt bonds. The specific details of the Administration's proposal to impose such additional limitations are described in the general and technical explanations released by the Treasury Department on February 26, 1982.

Nevertheless, despite our general view that tax-exempt financing for private purposes should be restricted rather than expanded, we do recognize that H.R. 4917 is intended to change a provision of the present law that treats New York City less favorably than other cities. Thus, we would not oppose making this change in connection with legislation to impose meaningful additional restrictions on tax-exempt financing for private activities. As an isolated matter, however, Treasury would oppose the bill.

H.R. 5985

Changes Relating to Taxes Paid to the Virgin Islands

[illegible]

[illegible] 85, and the position of the Treasury Department on [illegible] must be understood in the context of the pa[illegible]tem of taxation presently in effect in the Vi[illegible]s. While Treasury fully supports the broader ob[illegible] of the bill, particularly the goal of attracting investment to the Islands, we view with great concern the existing and potential tax abuses which result from the interaction of the "mirror code" system of taxation in the Virgin Islands and the U.S. Internal Revenue Code (the "Code"). The hallmark of the present Virgin Islands tax system is uncertainty -- which operates to the detriment of both the Virgin Islands and taxpayers with legitimate business interests, and benefits the unscrupulous. For reasons I will describe, we are reluctant to endorse piecemeal amendments to the present Virgin Islands tax system if such changes will increase potential tax abuse or delay comprehensive reform of the "mirror code" tax relationship.

The Treasury Department is opposed to the provisions of H.R. 5985 which would reduce the 30 percent Virgin Islands tax on payments of Virgin Islands source dividends, interest and other fixed or determinable income to persons not resident in the Virgin Islands or the United States, and which would allow a taxpayer to elect to take a foreign tax credit for certain Virgin Islands taxes under a relaxed foreign tax credit limitation provision. Despite grave concerns regarding any reduction in the Virgin Islands tax on dividends, interest and other fixed or determinable income, which I will discuss, the Treasury Department would be prepared to support a reduction in the Virgin Islands tax on such payments solely to U.S. persons.

In my testimony today I will briefly outline the Virgin Islands "mirror code" system of taxation and describe only some of the issues of its interpretation and application which face tax administrators and alternately enrage and enrich taxpayers. After describing the present regimen of Virgin Islands taxation, I will describe H.R. 5985 and explain in greater detail Treasury's position with respect to that legislation.

The income tax laws in force in the United States have, since 1922, been in force as the territorial income tax of the Virgin Islands. Congress established this tax system by the addition of a one-sentence rider to the Naval Appropriations Act of 1922, the precise intent of which is less than obvious. Administrative and judicial decisions have interpreted the provision to require the Code to be adapted for application in the Virgin Islands by substituting the name "Virgin Islands" for the name "United States," and *vice versa*, where appropriate to give the law proper effect. The result is referred to as the Virgin Islands "mirror code."

The question of whether a particular Code provision should be "mirrored" is, in many instances, not evident. Judicial decisions have charted an uneven path, "mirroring" some Code provisions and not "mirroring" others, in each case guided by their interpretations of Congressional intent underlying a provision for which there is little legislative history. I will provide specific examples of interpretative ambiguities under the "mirror code" later in my testimony.

A principal consequence of the mirror code is that U.S. individuals and corporations that are not "inhabitants" of the Virgin Islands are considered nonresident aliens and foreign corporations, respectively, for purposes of Virgin Islands taxation and are subject to the Code regimen of taxation relating to such types of persons.

The Code imposes a different regimen of taxation with respect to U.S. persons, i.e., citizens, residents and domestic corporations, and foreign persons, i.e., nonresident aliens and foreign corporations. In general, the former are subject to U.S. taxation on their worldwide income while the latter are subject to U.S. taxation on a more limited basis. More specifically, foreign persons are subject to U.S. taxation on a gross basis (without deductions) on fixed or determinable annual or periodical gains, profits and income ("fixed or determinable income"), e.g., dividends, interest, rents and royalties, from U.S. sources at a rate of 30 percent and on a net basis (net of deductions) on income effectively connected with the conduct of a U.S. trade or business at a rate and in a manner comparable to that of a U.S. person. These regimens of taxation may be modified by the application of a bilateral income tax convention. When these provisions are "mirrored," U.S. persons not resident in or "inhabitants" of the Virgin Islands are subject to a Virgin Islands tax on a gross basis at a rate of 30 percent on fixed or determinable income from Virgin Islands sources and on a net basis with respect to income effectively connected with the conduct of a Virgin Islands trade or business.

In 1954, Congress enacted section 28(a) of the Revised Organic Act of 1954 in order to allocate taxing responsibilities with respect to persons who were "inhabitants" of the Virgin Islands and to transfer additional revenues to the Virgin Islands. Section 28(a) provides that "inhabitants" of the Virgin Islands "shall satisfy their income tax obligations under the taxing laws of the United States by paying their tax on income from all sources both within and without the Virgin Islands into the Treasury of the Virgin Islands." "Inhabitants" of the Virgin Islands include U.S. citizens who are resident in the Virgin Islands as of the last day of their taxable year, corporations chartered in the Virgin Islands, and certain U.S. corporations which operate primarily in the Virgin Islands. In other words, Virgin Islands "inhabitants" are treated as domestic persons, i.e., Virgin Islands persons, for purposes of the Virgin Islands mirror code and pay no tax to the United States, even on U.S. source income.

Section 934(a), added to the Code in 1960, prohibits the Virgin Islands from granting relief, directly or indirectly, from Virgin Islands tax under the mirror code. However, an exception is made under section 934(b) with respect to non-U.S. source income of U.S. or Virgin Islands corporations that have derived at least 80 percent of their gross income from Virgin Islands sources and at least 50 percent of their gross income from the active conduct of a trade or business in the Virgin Islands during the preceding three taxable years. The Virgin Islands has established an industrial incentive program which provides tax rebates for

"934(b)" corporations which meet certain additional investment and employment criteria. A second exception allows Virgin Islands tax relief in respect of a mirror code tax liability of a U.S. citizen who is a bona fide resident of the Virgin Islands for the entire taxable year, to the extent the tax liability is attributable to Virgin Islands source income. These reductions do not operate, however, to reduce Virgin Islands taxes on payments of fixed or determinable income to U.S. or foreign persons. Such taxes generally cannot presently be forgiven under section 934, since the tax (usually collected through withholding at the source) is upon the recipient and not upon the company operating in the Virgin Islands.

For purposes of U.S. taxation, Virgin Islands income taxes paid by U.S. citizens, residents and corporations are creditable against U.S. tax under the foreign tax credit provisions of the Code. In addition, a so-called "deemed-paid" foreign tax credit is allowed upon the distribution of a dividend to a U.S. corporation that owns at least 10 percent of the voting stock of the payor foreign corporation, including a Virgin Islands corporation, with respect to a proportionate amount of the foreign taxes, including Virgin Islands taxes, paid by the foreign corporation on or with respect to the accumulated profits from which the dividend is paid. The amount of taxes which are creditable in any taxable year is subject to the overall foreign tax credit limitation at section 904. The amount of Virgin Islands and other foreign taxes which are allowed as a credit in a taxable year equals the lesser of the foreign taxes paid or the portion of the taxpayer's tentative U.S. tax, calculated before applying the foreign tax credit, which the taxpayer's foreign source taxable income (including Virgin Islands source taxable income) for the taxable year bears to the taxpayer's total taxable income for the taxable year. Excess foreign taxes may be carried back two years and carried forward five years.

The interaction of the Revised Organic Act and the Virgin Islands mirror code with the U.S. Internal Revenue Code gives rise to innumerable problems of interpretative ambiguity and potential tax abuse. One example which is familiar to this Committee involved the use of a Virgin Islands corporation by a foreign person as a vehicle to acquire and dispose of U.S. real estate in a manner which avoided taxation under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). This abuse was eliminated by section 831(a) of the Economic Recovery Tax Act of 1981. The experience with FIRPTA highlights the potential for manipulation of the Virgin Islands mirror code and Revised Organic Act for tax avoidance purposes. Many other problem areas, uncovered by the Treasury Department or raised in inquiries by taxpayers, remain. The following are examples.

A strict "mirroring" of the Code would permit a Virgin Islands subsidiary to claim a tax credit against Virgin Islands tax for income taxes paid to State and local governments in the United States. While it is not appropriate to mirror Code section 901 in this fashion, corporations, whether foreign or U.S., could seize upon such an ambiguity and establish Virgin Islands subsidiaries to conduct operations in the fifty States for the purpose of claiming a credit for State income taxes against Virgin Islands tax under the mirror code. To the extent that corporations would not incorporate in the Virgin Islands absent such a tax benefit the Virgin Islands might not have an incentive to contest such an interpretation.

The mirror system gives rise to potential tax abuse by individuals, as well as corporations. For example, a correspondent has raised in a letter the issue of whether interest on U.S. Treasury bonds is taxable to a Virgin Islands resident. It has been suggested that section 742 of Title 31 of the United States Code, which provides that obligations of the United States shall be exempt from taxation by, or under, State or local authority, operates to exempt such income from Virgin Islands taxation (and the Revised Organic Act precludes U.S. Federal income taxation). Section 742 of Title 31 is not applicable, however, because the Virgin Islands territorial tax is imposed under Federal authority, that is, the Naval Appropriations Act of 1922. It has been alternatively suggested that a strict mirroring of Code section 103(a) would require that "gross income" not include interest on an obligation of the United States. Such a mirroring would be utterly inappropriate. In light of the state of the law, however, it is not surprising that a hopeful taxpayer raised the issue.

The Treasury Department is convinced that comprehensive legislative reform is needed to remedy the technical difficulties in the Virgin Islands mirror code and the Revised Organic Act. Absent legislative reform, the Treasury Department will be required to take administrative actions, including the issuance of revenue rulings, to deal with these technical issues. Because the potential rewards may be great, taxpayers may, in some cases, continue to adopt interpretations of the law which, though barely colorable, could not have been the intent of Congress. The consequence would be that uncertainty would remain. Illustrative of this problem is the continuing controversy, despite the issuance of new administrative guidelines by the Treasury Department, regarding the obligation of Virgin Islands persons to withhold the 30 percent tax on payments of fixed or determinable income to persons who are not resident in the Virgin Islands. The perpetuation of uncertainty frustrates attraction of the legitimate, stable business investment that the Virgin Islands requires.

The Treasury Department has studied the problems of the Virgin Islands tax system at length and is prepared to work with Representative de Lugo and the Virgin Islands government to fashion a comprehensive legislative solution to the problems presented by the current system of taxation which would both encourage investment in the Virgin Islands and preserve the integrity of the U.S. tax system. Regretably, H.R. 5985 does not constitute such a solution. The objective of H.R. 5985, to reduce taxes on investments in the Virgin Islands by nonresidents and foreign corporations, particularly those from the U.S. mainland, is important -- and is shared by the Treasury Department. While Treasury must oppose the approach taken by H.R. 5985, for the reasons I will discuss, Treasury would be prepared, as an interim measure, to support a reduction in the Virgin Islands withholding tax on payments to U.S. persons.

Description of the Bill

Section 1 of the bill would, in a new Code section 934A, reduce from 30 percent to 10 percent the rate of Virgin Islands tax imposed on payments of fixed and determinable income from sources within the Virgin Islands, not effectively connected with a Virgin Islands trade or business, to persons not resident in the Virgin Islands. The tax reduction would apply to payments to persons resident in foreign countries as well as in the United States. New section 934A would also allow the Virgin Islands to further reduce the effective rate of tax by excluding this tax from the scope of the proscription in section 934(a) against direct or indirect reductions in tax liability under the Virgin Islands mirror code.

The new rate of tax on fixed or determinable income would not apply to dividends from earnings and profits accumulated before the effective date of the reduction. For this purpose, dividends would be treated as being derived first from such pre-effective date earnings. A new section 1444 would be added to Chapter 3 of the Code to conform the rate of withholding to the reduced tax rate. The reduced tax rate would apply to amounts received and the withholding provisions would apply to payments made after the date of enactment.

Section 2 of the bill would add a new section 934B to the Code which would allow a U.S. citizen or resident, a resident of Puerto Rico, or a domestic corporation to elect to credit "Virgin Islands withholding taxes" together with certain "deemed paid Virgin Islands taxes" under 902 against U.S. taxes, up to the amount of a person's tax liability after utilization of the regular foreign tax credit. "Deemed paid Virgin Islands taxes" would only include deemed paid taxes determined under section 902 with reference to

(i) accumulated profits from Virgin Islands source income and dividends therefrom, and (ii) taxes paid or deemed to be paid by the foreign corporation to the Virgin Islands. The amount of the deemed paid Virgin Islands taxes allowed as a credit would be limited to that portion of the deemed paid Virgin Islands taxes which the dividends taken into account in computing the deemed paid Virgin Islands taxes plus section 78 gross-up for such dividends bears to the total taxable income of the corporation. The election to use this special Virgin Islands foreign tax credit would be annual. Unused credits could be carried back two years (but not to a taxable year ending before the date of enactment) and forward five years, without absorbtion in years in which the section 934B credit is not elected. The credit would be effective for taxable years ending after the enactment of the Act.

Discussion

I have previously discussed aspects of Treasury's broader concerns regarding the interrelationship between the Virgin Islands and U.S. tax systems. A reduction in the tax on payments of Virgin Islands source fixed or determinable income, such as interest and dividends, to non-Virgin Islands residents or corporations would facilitate the use of the Virgin Islands solely for tax avoidance purposes. Accordingly, we would oppose, in principle, any such reduction while the present problems with the Virgin Islands tax system exist. However, we are aware of the Virgin Islands pressing needs and that it takes time to agree on broader solutions to such difficult problems. Recognizing this, we would be prepared to support a reduction in the rate of tax on Virgin Islands source payments of fixed or determinable income to U.S., but not foreign, persons, solely as an interim measure. In this way, legitimate investment from the United States would be encouraged during the period that it took to remedy the broader problem.

This policy is consistent with the U.S. tax policy toward Guam. Under the Guam mirror code, a 30 percent tax is imposed on payments of Guam-source fixed or determinable income to foreign corporations and nonresident aliens, but imposes no tax on such payments to U.S. persons. The legislation which the Treasury Department is prepared to support as an interim solution for the Virgin Islands would allow the Virgin Islands, like Guam, to eliminate its tax on Virgin Islands source payments of fixed or determinable income to U.S. persons.

We cannot extend our support to a reduction in the rate of tax on Virgin Islands source payments of fixed or determinable income to foreign persons, that is, persons not resident in or organized under the laws of the United States or the Virgin Islands. A reduction in the rate of Virgin Islands tax, combined with the provisions of the Revised Organic Act, would permit the use of the Virgin Islands as a conduit for investment into the United States by a national of a country with which the United States does not have a tax treaty. This would be contrary to the United States' strong policy against allowing residents of non-treaty countries to obtain unbargained-for tax benefits. To the extent that nationals of non-treaty partners can invest in the United States at reduced tax rates without a tax treaty, our ability in tax treaty negotiations to bargain for reductions in taxation of U.S. investment by the host country is compromised. The implications of conduit investments resulting from a reduction in the Virgin Islands tax would also undermine the efforts of this Administration to fashion appropriate protections in our treaties against interposition of a treaty protected entity by third country nationals to invest in the United States.

Treasury must therefore oppose a reduction in the Virgin Islands tax on payments of Virgin Islands source fixed or determinable income to foreign persons.

Finally, Treasury must also oppose the foreign tax credit provisions of the bill. Section 934B addresses the problem of excess Virgin Islands tax credits which results when the total of (i) taxes deemed paid by a Virgin Islands corporation to the Virgin Islands under section 902, plus (ii) the Virgin Islands withholding tax on dividends paid by the Virgin Islands corporation to a U.S. parent corporation, exceeds 46 percent of the amount of the dividend. This problem is obviated if the Virgin Islands tax on payments of Virgin Islands source fixed or determinable income to U.S. persons is reduced.

Treasury would, in any event, oppose an exemption from the application of the foreign tax credit limitation for taxes paid to the Virgin Islands on fixed and determinable income and deemed paid Virgin Islands taxes. Such an exemption would, in certain circumstances, allow these Virgin Islands taxes to offset U.S. taxes on taxable income which is not from the Virgin Islands, including U.S. source taxable income. This is contrary to the policy behind the foreign tax credit limitation, which has been in effect, in "overall" or "per country" form, since 1921. The United States only allows a credit for foreign taxes paid to the extent of the United States tax that would have been paid on the taxpayer's foreign source taxable income. The United States is opposed to offsetting U.S. taxes on U.S. source income with the foreign tax credit because it would constitute a transfer of revenues from the U.S. Treasury to the treasury of the other jurisdiction. Treasury is opposed to increasing the tax based subsidies to the Virgin Islands in this manner.

In this regard, the Committee should be aware that the Administration's Caribbean Basin Initiative legislation includes generous additional tax incentives to invest in the Virgin Islands. These measures include allowing a parent of a domestic "934(b)" corporation to obtain the benefit of a full investment tax credit and 50 percent of the ACRS deductions with respect to eligible property of the domestic "934(b)" corporation.

In summary, the Treasury Department must oppose H.R. 5985, except to support, as an interim measure, a reduction in the Virgin Islands tax on payments of Virgin Islands source fixed or determinable income to U.S. persons.

H.R. 6218

Exemption For Insurance Organizations for Veterans

H.R. 6218 would create a new category of tax exemption for certain organizations formed prior to 1880 which provide insurance benefits to past or present members of the Armed Services and their spouses and dependents. In order to understand the purpose and effect of this bill, it is necessary to examine the legislative history of the tax treatment of war veterans associations.

Prior to the enactment in 1972 of Code section 501(c)(19), which grants tax exempt status to organizations at least 75 percent composed of war veterans, most veterans organizations qualified for exemption as social welfare organizations under section 501(c)(4). Their subsidiaries, such as wholly-owned organizations to maintain and operate social facilities, were also sometimes recognized as exempt social clubs under section 501(c)(7). In addition to their other activities, many veterans organizations provide one or more types of insurance to their members and to dependents of their members. In some cases, the organizations serve as commissioned agents for insurance companies that provide the actual insurance, and accordingly receive on a commission basis portions of the insurance premiums paid by their members. In other cases, veterans organizations receive income from their own provision of insurance benefits for their members and dependents.

Before the enactment of the Tax Reform Act of 1969, there was no tax on the insurance activities of veterans organizations, since the unrelated business income tax did not apply to social welfare organizations or to social clubs. The 1969 Act extended the application of the unrelated business income tax to virtually all exempt organizations, including social welfare organizations and social clubs. However, the insurance activities of voluntary employees' beneficiary associations (under section 501(c)(9)) were specifically exempted from the unrelated business income tax (under section 512(a)(3)).

In 1972, in recognition of the fact that war veterans associations were all potentially subject to unrelated business income tax on their insurance activities, Congress enacted a special exemption category, section 501(c)(19), together with an amendment to section 512, which provides treatment similar to that accorded Code section 501(c)(9) organizations to any qualified war veterans association conducting insurance activities. This new exemption category, which was made effective retroactive to 1969, does not apply to all veterans organizations, but instead generally follows the definition of "war veterans" organizations in Code section 170(c)(3), which since 1918 has provided a charitable deduction for contributions to any organization composed primarily of war veterans. Presumably Congress believed that this special exemption from unrelated business income tax for insurance activities of veterans organizations should be available only for those organizations whose members had joined for the purposes of maintaining and promoting comradeship among persons who have actively served in the U.S. Armed Forces during wartime, as opposed to having joined for purposes of a social or legislative nature. Accordingly, in order to qualify for tax exempt status under Code section 501(c)(19), a veterans group must be a "post or organization" established in the United States, have a membership of at least 75 percent war veterans, and not permit net earnings to inure to the benefit of private individuals. The "war veterans" who must comprise 75 percent of the membership of a qualified organization are defined by the regulations to be any persons who served in the U.S. Armed Forces during a period of war (including the Korean and Vietnam conflicts). Substantially all of the remaining members of the organization must be spouses, widows or widowers of war veterans, veterans other than war veterans, and military cadets.

The charitable purposes of qualifying organizations can include programs to promote community welfare, to assist disabled and needy war veterans, to entertain hospitalized veterans, to memorialize deceased veterans, to sponsor and participate in patriotic activities, to provide information and educational programs relative to national security and foreign affairs, and to provide social and recreational activities for their members. Finally, qualifying organizations can provide insurance benefits, and are exempt from unrelated business income tax on any payments attributable to life, sickness, accident, or health insurance coverage with respect to members or their dependents, to the extent this income from insurance activities is set aside either for the purpose of providing for the payment of insurance benefits or for a qualified charitable purpose specified in section 170(c)(4). No part of the net earnings of a section 501(c)(19) organization may inure to the benefit of any member or other individual.

Veterans organizations that fail to qualify under section 501(c)(19) can obtain exemption for income from their insurance activities only if they can qualify under section 501(c)(9) as voluntary employee beneficiary associations. Notably, the Army Mutual Aide Association and the Navy Mutual Aide Association never sought exemption under section 501(c)(19), but instead have always based their respective exemptions on section 501(c)(9).

There are two problems currently faced by veterans organizations that conduct insurance activities. First, with respect to many organizations that have previously qualified under section 501(c)(19), the combination of a prolonged period of peace and the natural attrition rate among surviving war veterans is rapidly reducing the requisite percentage of members who are "war" veterans. This problem is not faced by all veterans organizations. For example, organizations like the Disabled American Veterans Association, or the Veterans of Foreign Wars, are, as indicated by their titles, substantially composed of war veterans, and are not therefore hindered by the 75 percent limitation. However, those organizations that are faced with the 75 percent limitation problem have proposed several bills since 1979 to amend the membership test for section 501(c)(19) organizations, by requiring that at least 75 percent of the members be past or present members of the U.S. Armed Forces, without regard to whether these veterans have served during a period of war. Because of the preferential treatment received by these organizations as compared to other social welfare organizations and insurance companies, the Treasury has consistently opposed these attempts to broaden the membership requirements of war veterans associations. Our most recent statement of our position in this area was made before this Subcommittee on March 16, 1981, in opposition to H.R. 2597.

Second, with respect to organizations that have previously qualified under section 501(c)(9), their sales of whole life insurance have been recently questioned by the IRS, on the grounds that the utilization of permanent life insurance contracts by section 501(c)(9) trusts funded through deductible employer contributions could create opportunities to provide untaxed deferred compensation outside the qualified plan area, that could be categorized as inurement of benefits to organization members. Alternatively, the cost savings on premiums for whole life insurance offered through tax-exempt veterans organizations, as compared to market prices on individual policies offered by commercial insruance companies, also potentially represents prohibited inurement to organization members. These organizations can qualify under section 501(c)(19) or (c)(9) only if the offering of whole life insurance is not deemed to be inurement.

H.R. 6218 attempts to solve both of these problems, by creating an entirely new category of exemption under section 501(c)(23) for any association which is organized prior to 1880, is composed more than 75 percent of past and present members of the Armed Forces or of spouses or dependents of past or present members of the Armed Forces, and is operated primarily to provide insurance benefits to veterans or their dependents. We understand that this bill would benefit primarily the Army Mutual Aide Association and the Navy Mutual Aide Association, two large veterans associations founded prior to 1880 that are currently qualified for exemption under section 501(c)(9). These organizations have never been able to qualify under section 501(c)(19), primarily because they are hindered by the statutory 75 percent membership limitation, and also because these two associations fear that they cannot be strictly defined as a "post or organization" of veterans, as is required by section 501(c)(19). Finally, these organizations would be disqualified under both section 501(c)(19) and section 501(c)(9) if their sales of whole life insurance were deemed to violate the prohibition against inurement.

In order to overcome these various problems, these two organizations have proposed a bill that, except for its limitation to organizations founded prior to 1880, is significantly broader than prior bills, like H.R. 2597, that simply would have permitted non-war veterans to be included in the 75 percent membership limit. H.R. 6218 includes spouses and dependents of service veterans, as well as non-war veterans, within the 75 percent limit; it deletes the requirement that the organization be a "post or organization" established in the United States; it specifically permits these veterans organizations to be organized for the primary purpose of selling insurance; and it deletes the statutory prohibition against inurement.

Treasury opposes H.R. 6218 for several reasons. First, by permitting both non-war veterans and veterans' spouses and dependents to be counted within the 75 percent membership limitation, the bill significantly broadens the membership of organizations that can operate as tax-exempt insurance companies or agencies. It may be possible to justify the present law exemption from unrelated business income tax for insurance activities of section 501(c)(19) organizations on the grounds that this exemption is limited to organizations of persons who have been in combat in service of this country. We do not believe, however, that this generous statutory scheme should be extended to all persons who are or have been members of the Armed Forces as well as to the spouses and dependents of all service veterans. Treasury would support such a broadening of the membership requirements only if the organizations were to be subject to income tax on the net income from their insurance activities.

Secondly, Treasury is concerned by the limited application of H.R. 6218, which singles out two veterans associations for preferred treatment relative to all other veterans organizations. If this bill were enacted, the Army and Navy Mutual Aide Associations would be the only two veterans organizations specifically authorized by section 501(c) of the Code to operate as tax-exempt insurance companies or agencies. Any other veterans organization either would be subject to the 75 percent membership requirement of section 501(c)(19) (in which case the exemption under section 512(a)(4) from unrelated business income tax for insurance activities would be available), or could qualify for exemption under section 501(c)(4) (in which case it would be subject to unrelated business income tax on insurance activities). Finally, if H.R. 6218 were adopted, the Army and Navy Mutual Aide Associations would receive preferential treatment even in comparison to other section 501(c)(9) organizations, to the extent that these voluntary employee benefit associations are prohibited under the inurement provision from selling whole life insurance. If these organizations wish to sell whole life insurance to a broadened class of association members, they should be required to pay tax on the income from this insurance business.

To summarize, Treasury does not oppose a broadening of the membership requirements of veterans organizations per se. However, we do oppose any broadening of the class of individuals to whom these organizations can effectively pass on the benefits of their tax exemption on insurance income. Any veterans organization seeking to market insurance to a broader group of individuals than is currently permitted should be taxed instead like a social welfare organization described in section 501(c)(4), and be subject to unrelated business income tax on the net income from its insurance activities.

Chairman STARK. Our next witness is Hon. Carl T. Curtis, counsel for the Don Rich Co.

STATEMENT OF CARL T. CURTIS, COUNSEL, DON RICH CO., ACCOMPANIED BY J. B. WILSON

Mr. CURTIS. Thank you, Mr. Chairman.

Chairman STARK. Welcome to the committee.

Your full statement will appear in the record. If you would care to summarize in any way you see fit, you may proceed.

Mr. CURTIS. Thank you, Mr. Chairman. I must consume 10 seconds of my time to express my high regard for this committee where I served for 10 years.

This is an appeal that means life or death to a small businessman. He started out fixing up this fish bait in his kitchen, graduated to his garage, now he has a small factory employing 11 people. I would remind the committee that there is a tax on artificial baits and lures.

There is no tax on all bait. As a matter of fact, the section that imposes this tax has this language, also, after "artificial baits and lures, including parts and accessories of such articles."

The taxpayer manufactures an edible fishbait. It is not artificial, not at all. This gentleman, this small businessman with 11 employees, his lawyer made an inquiry about tax to the IRS, said it is basically cheese.

The question was if that was taxable. This was an oral exchange. The answer was it was not.

Five years later the IRS knocked on his door and said, "We are going to tax your bait."

If they are successful, Mr. Chairman, the amount they claim exceeds the net worth of his business a couple of times. Now, that is what it means to him.

To the Treasury it is so small it can't be estimated.

You can't get an estimate on the cost of this bill.

The staff says it is very negligible.

Now, the tax is on artificial bait. This bait is edible, it is not artificial.

Artificial bait can be made of metal, cloth, plastic, wood, rubber, and the like.

One of the best places to determine what is artificial bait and what is not is the State regulations, because you will go to a stream where you will be advised you can use nothing but artificial baits and lures in certain waters.

If you went to one of those fishing places and attempted to use this fish bait, Zeke's Floating Bait, you would not be allowed to fish there, because it is edible. It is not artificial.

Here is what the New York regulations say: "Artificial lures and bait mean manmade flys, spinners, spoons, plugs, jigs and other lures."

And then it goes on to say, "Natural bait means all bait which entices or might be ingested and swallowed by fish including but not limited to fish eggs, fish, dead and live, worms, shellfish, insects, pork rinds, liver, meat, corn, other vegetable matter, tapioca, candy, cheese and bread."

Artificial baits and lures are well defined by the States because it determines what kind of fishing you can do in a certain location. The Pennsylvania regulations are very similar.

Mr. Chairman, this is all that we ask, that the committee define artificial bait and lures. It is definitely not taxed now.

The Treasury would be imposing a tax by regulation and doing it retroactively.

The Treasury has this statement, "On the other hand, it is completely consistent with the theory and purpose of the tax to impose it on all manufactured items that are edible as bait at the time of their sale by the manufacturer."

Mr. Chairman, it is well established, law held by the courts, that an excise tax which is passed on to the customer, that it must be clear and definite and if there is any doubt it should be decided against the Government.

Mr. Chairman, here is an artificial bait, it can be eaten by fish and it can be eaten by fishermen, and it is a natural bait, not an artificial bait.

We feel that the Congress should define what is artificial. We think that we have come up with a good definition in this bill, and we respectfully express the hope that the committee will favorably report the bill.

[The prepared statements follow:]

STATEMENT OF CARL T. CURTIS, COUNSEL, DON RICH CO.

Mr. Chairman:

I am most grateful for this opportunity and I thank you. The distinguished Representative from California, Mr. John Rousselot who is a member of this Committee, and the distinguished Representative from California, Mr. Jerry Lewis, have introduced H.R. 617. This bill is identical to the Senate bill S. 599, which was introduced by Senators Hayakawa and Cranston of California. The body of these bills is as follows:

> "Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 4161 of the Internal Revenue Code of 1954 (relating to imposition of tax on sporting goods) is amended by adding at the end thereof the following: 'Provided, That the term 'artificial bait' as used in the preceding sentence shall not include any substance which contains 85 percent or more by weight of plant or animal material which can be ingested by fish.'"

Mr. Frank Witteman of the Don Rich Company started to manufacture his fish bait in his kitchen. Later he moved to the garage. Now he and his family operate a small factory and it has grown from 1 employee to 11. The purpose of these bills is to incorporate in the statutes a definition of artificial fish bait.

The present law places a ten percent excise tax on "artificial" bait. Mr. Witteman's product is not artificial. It is made almost entirely of plant and animal material. It is edible and can be ingested by fish. It is called "Zeke's Floating Bait." Artificial bait might be made of metal, cloth, plastic, wood, rubber or some other substance. Artificial bait is not edible and it cannot be ingested by fish. The definition proposed here is in conformity with state laws and regulations which define artificial bait.

Early in Mr. Witteman's activities, an inquiry was made of the Internal Revenue Service and his lawyer was told in an oral opinion that his bait was not taxable. Five years later, the IRS claimed it was taxable and if this view prevails, the taxpayer would face a tax claim which would exceed the net worth of the entire business. It is a matter of survival.

The chief competitor of Zeke's Floating Bait is soft cheese which is sold not only in grocery stores but in sporting goods stores. Cheese, of course, is not taxable and this edible bait which can be ingested by fish should not be taxable.

The proposal before the Committee provides that artificial bait shall not include any substance which contains 85 percent or more by weight of plant and animal material which can be ingested by fish. This is an understandable and easily administered definition and believed to be in conformity with the original intent of the law.

According to the staff, the effect on revenue by the passage of the measure is negligible but it is a matter of survival for an otherwise going small business.

Mr. Chairman, I would like to incorporate into the hearings the following material and I ask that it be printed and made a part of the record.

The statements presented here were made in the previous 96th Congress, and are so dated, but the situation has not changed as these statements are presented here today.

These statements relate to the Senate bill as it was numbered in the 96th Congress, but the language of that bill is identical with the House bill and the Senate bill now before this Committee. The statements I refer to are as follows:

1) The description of the proposal which was prepared in reference to S.2179 by the staff of the Joint Committee on Revenue Taxation on April 25, 1980.
2) The statement of Mr. Frank Witteman of the Don Rich Company of Ponoma, California.
3) The statement of April 25, 1980 of Mr. James L. Wilson, a distinguished tax lawyer in Washington, which was made before the Senate Finance Committee.
4) A statement of Representative Jerry Lewis of California.
5) A statement of Representative John Rousselot of California.
6) The statement made before the Committee on Finance of the U.S. Senate by Senator S. I. Hayakawa of the State of California.
7) The statement of Senator Alan Cranston of California before the Committee on Finance of the U.S. Senate on April 25, 1980.

6. S. 2179—Senators Hayakawa and Cranston

Definition of Artificial Bait for Purposes of the Excise Tax on Fishing Equipment

Present law

Under present law, there is imposed upon the sale of fishing rods, creels, reels, and artificial lures, baits, and flies (including parts or accessories of such articles sold on or in connection therewith, or with the sale thereof) by the manufacturer, producer, or importer a tax equivalent to 10 percent of the price for which so sold (Code sec. 4161(a)).

Present law contains no statutory definition of "artificial bait" to which the tax applies. However, Treasury Regulations (Treas. Regs. sec. 48.4161(a)-2(d)) define the term "artificial lures, baits, and flies" to include all artifacts, of whatever materials made, that simulate an article considered edible to fish, and that are designed to be attached to a line or hook to attract fish so that they may be captured. Thus, the term includes such artifacts as imitation flies, blades, spoons, spinners, etc., and edible materials that have been processed so as to resemble a different edible article considered more attractive to fish, such as bread crumbs treated so as to simulate salmon eggs, and pork rind cut and dyed to resemble frogs, eels, or tadpoles.

The Internal Revenue Service has taken the position that bait which contains very little artificial substance may be subject to the excise tax. In Revenue Ruling 71-321, 1971-2 C.B. 369, the Service holds that edible food items which are shaped or treated to give the appearance or odor of insects, flies, worms, frogs, etc., are artificial lures or baits. In addition, in Revenue Ruling 77-302, 1977-2 C.B. 374, the Service held that a floating fish bait that is manufactured from a semi-soft cheese food to which ingredients are added to provide the desired consistency, color, scent, and buoyancy, then packaged by weight and sold in a solid form that the user may shape or form, as with a fish hook, is an artificial bait or lure subject to the manufacturer's excise tax.

Issue

The issue is whether certain substances should be excluded from the term "artificial bait," for purposes of the excise tax.

Explanation of the bill

The bill would exclude from the term "artificial bait" any substance which contains 85 percent or more by weight of plant or animal material which can be ingested by fish. Thus, those types of substances would be exempt from the excise tax.

Although this provision may benefit other taxpayers, it is intended primarily to benefit the Don Rich Company, Inc., of La Canada, California, which produces "Zeke's Floatin' Bait." This bait has a base of processed cheese to which is added certain artificial ingredients which make the cheese easier to thin and mix and which give the bait its floatation characteristics.

Effective date

The bill would apply with respect to sales made after December 31, 1979.

Revenue effect

It is estimated that this bill would reduce budget receipts by a negligible amount.

STATEMENT OF FRANK WITTEMAN

Mr. Chairman:

My name is Frank Witteman. I operate a small company which is named the Don Rich Company. It is located in Pomona, California. I appear here as an operator of a small business facing a tax problem which, I believe, the Congress when informed of the facts, will be anxious to correct.

I am the manufacturer of an edible fish bait which is made up almost entirely of plant and animal material and this bait can be ingested by the fish.

My product is called "Zeke's Floating Bait." It is a bait for trout. I first developed it for my own use. I found this bait to be an excellent aid in the catching of trout and soon the fellow members of a fishing club to which I belong were anxious to have some of this bait to use. Later a patent was issued to me. When I first began, I made my product in the kitchen, then later I moved my operation to the garage. It was a family production. My family and I did all the work in the manufacture, packaging and selling of the product. Finally, the volume of our business reached a point where we opened a factory to manufacture Zeke's Floating Bait. We have grown from one employee to the employment of 11 people.

On one occasion I was attending a trade show and while there I was involved in a conversation that caused me to investigate the status of my product in reference to the federal excise tax. I learned that there was not a tax on all bait used by fishermen, but rather that the law imposed a tax on "artificial bait." My product was not artificial, it was made of natural substances with only traces of ingredients other than plant and animal substances. It was edible and the fish could readily ingest it.

Section 4161(a) of Title 26 of the Internal Revenue Code reads as follows:

> "There is hereby imposed upon the sale of fishing rods, creels, reels, and artificial lures, baits, and flies (including parts or accessories of such articles sold on or in connection therewith, or with the sale thereof) by the manufacturer, producer, or importer a tax equivalent to 10 percent of the price for which so sold."

In April 1971, I consulted my lawyer about this excise tax matter. My lawyer contacted the nearby Internal Revenue Service office. He described my product and was advised orally that it was not subject to the excise tax. I have in my file the letter from my lawyer reciting these facts.

I thought this solved my problem. I knew that I was not making an artificial bait, but, unfortunately, my problems were not over. Five years later the Internal Revenue agents knocked on my door and told me that it was their contention that my product was subject to the 10 percent excise tax. What is more, they advised me that there would be a sizable amount of tax assessed retroactively. It is my opinion that this claim against me is not only unjust, it is unbearable. I don't see how I can continue in business if the contention of the Internal Revenue Service prevails. The market for fish bait is highly competitive. It is competitive with every other edible substance used for catching trout. In fact, I can't even pass the tax along to my customers; I have to pay it myself in order to remain competitive. One of the principal competing items is soft cheese that can be purchased at any grocery store. But, you don't have to go to a grocery store to get it. Many of the sporting goods stores or other types of stores that carry fishing equipment also carry on the same shelves items such as cheese, which, of course, has not been taxed by the federal government.

My product is sold in jars. I have some of it here for your inspection. It is natural substances, not artificial. Although I am not a lawyer, I would like for you, Mr. Chairman, to take a look at this Section of the Internal Revenue Code to which I have referred. The Section does not place a tax on all fish bait. The tax is placed upon artificial fish bait. Artificial bait might be made of metal, cloth, plastic, wood, rubber or some other substance. Artificial bait is not edible and it cannot be ingested by fish. I also call your attention to the language of this Section of the Act which says, "including parts or accessories of such articles sold on or in connection therewith." An edible fish bait would not have parts or accessories. It is evident that the Congress intended that the tax would apply only to fish bait made of something other than natural substances which is edible and ingested by the fish.

I am very grate to Congressmen Jerry Lewis and John Rousselot who have introduced legislation that is now before your committee. This legislation would add the following sentence to the section of the statute, to wit: "Provided, That the term 'artificial bait' as used in the preceding sentence shall not include any substance which contains 85 percent or more by weight of plant or animal material which can be ingested by fish."

The same words - "artificial bait" - are contained in many state fishing regulations, for example, Mr. Chairman, I have before me a publication entitled, "Fishing", put out by the State of New York. It is a map but it is also a guide for fishermen. Due to the fact that fishing is limited in some lakes and streams to artificial lures and baits, they have chosen to define what is artificial and it reads as follows: "Artificial lures or bait mean man-made flies, spinners, spoons, plugs, jigs and other lures, even though there may be some natural substances contained in such lures as, but not limited to, deer hair and feathers, and artificial imitation of natural bait." That same publication also describes natural bait as follows: "Natural bait means all baits which entice or might be ingested or swallowed by fish including, but not limited to, fish (dead or alive), fish eggs, worms, shellfish, crustacea, amphibians (salamanders, frogs and toads), insects, (including all stages of development as larvae, pupae, etc.), pork rinds, liver, meat, corn or other vegetable matter, tapioca, candy, cheese and bread.

The State of Pennsylvania, in its 1979 publication of a summary of fishing regulations, has this to say about artificial lures and baits. It reads as follows: "Standard 'Fish-For-Fun' regulations in effect, except that fishing may be done with artificial lures, only, constructed of metal, plastic, rubber or wood; or flies or streamers constructed of natural or synthetic materials. All such lures may be used with spinning or fly fishing gear. Anything other than described in this regulation is prohibited."

Mr. Chairman, I am convinced that if the Congress had intended to tax all fish bait, they would have done so. Congress limited the tax to artificial bait. What we are asking here is clarification of what is artificial bait. In behalf of my family who are involved in this business with me, and my employees, I earnestly urge your favorable consideration of the Lewis and Rousselot bills.

STATEMENT OF JAMES L. WILSON

Mr. Chairman:

My name is James L. Wilson. I am an attorney with the law firm of Colton and Boykin in Washington, D.C. I have represented the Don Rich Company, a maker of fish bait, for nearly four years now in connection with the federal excise tax on artificial lures, baits and flies. I offer this statement in support of S. 2179, a bill to clarify the meaning of the term "artificial bait". Following is a brief review of the applicable legislative history, rulings and regulations concerning the tax on artificial baits. I have compiled this in the hope that it will prove helpful to your Committee and staff.

The tax on fishing equipment, including artificial baits, has historically been included in the excise tax on sporting goods. The excise tax on sporting goods was first enacted in the Revenue Act of 1918. This tax applied only to fishing rods and reels and not to artificial lures, baits and flies, and was repealed after the First World War. The general manufacturer's excise tax in its modern form was enacted in the Revenue Act of 1932. This tax once again included fishing rods and reels. The excise tax on sporting goods was repealed in 1938, but then reenacted in the Revenue Act of 1941. The 1941 Act extended the tax on fishing equipment to rods, reels, creels, and artificial lures, baits and flies. This provision was carried over into the Internal Revenue Code of 1954. Although the bulk of the tax on sporting goods was later repealed by the Excise Tax Reduction Act of 1965, the tax on fishing equipment was left unchanged as section 4161(a) of the Code.

Mr. Chairman, the bill before your subcommittee, S. 2179, is intended to clarify the term "artificial baits" as it is used in the manufacturer's excise tax. The Internal Revenue Service has, through its regulations and public and private rulings, extended the coverage of the tax to baits made of natural substances. This extension has caused confusion, with potentially ruinous consequences, among taxpayers.

The Internal Revenue Service first hinted that it may consider the tax definition of the word "artificial" to be different from the ordinary layman's understanding of it in Revenue Ruling 60-225. In that ruling, the Service stated that artificial lures include all objects designed and produced for use to attract fish, and that "[t]he type of material from which these objects are produced is of no significance." 1960-1 C.B. at 489.

In another revenue ruling issued in 1971, the Service took the position that wholly natural substances could be artificial if they arguably resemble another natural substance "considered attractive to fish." The ruling held that bread crumbs or marshmellows which were coated with gelatin or fish oil, and plain pork rind cut to resemble frogs, eels or tadpoles, were taxable artificial baits. In so holding, the ruling stated:

> "Edible food items designed to atttract fish are artificial lures or bait within the meaning of section 4161 of the Code if the food is shaped or treated so as to give the appearance or odor of any substance considered attractive to fish generally, or to a particular species of fish.
>
> "The articles described above are not in the form of a "natural" food for fish but are designed and produced to resemble or simulate something a fish would eat." Rev. Rul. 71-321, 1971-2 C. B. 369.

This idea that a natural substance could become "artificial" by virtue of its resemblance to some other substance was continued in the Treasury Regulations which were issued with respect to this section of the Code in 1974. The regulations state:

> "The term 'artificial lures, baits and flies' includes all artifacts, of whatever materials made, that simulate an article considered edible to fish, and that are designed to be attached to a line or hook to attract fish so that they may be captured. Thus, the term includes such artifacts as immitation flies, blades, spoons, spinners, etc., and edible materials that have been processed so as to resemble a different edible article considered more attractive to fish, such as bread crumbs treated so as to simulate salmon eggs, and pork rind cut and dyed to resemble frogs, eels or tadpoles." 26 C.F.R. §48.4161(a) - 2(d).

A final public ruling was issued in August of 1977 with respect to a product identical to one made by the Don Rich Company. The Service then took the position that artificial baits included, but were not limited to, natural products that were imitative of other substances "considered attractive to fish." The product addressed in the ruling was a semi-soft cheese food which was sold in jars and not made to resemble any living thing. Small quantities (about 4%) of other ingredients were added to give the cheese color, scent and flotation characteristics. The ruling held that the purpose of the manufacturer in processing the cheese was to make it more attractive to fish. Moreover, the factors of (a) whether the ingredients may be "natural", (b) whether the bait is edible, and (c) whether the article is actually effective in capturing fish, were held to be immaterial. The Service articulated its conclusion as follows:

> "Consequently, any ingredient or characteristic added to an article (that normally articles of that type do not have) for the purpose of making the article more attractive to fish will make that article an artificial lure or bait if it is designed to be attached to a line or hook." (emphasis added) Rev. Rul. 77-302, 1977-2 C. B. 374.

Thus, the Service's published rulings and regulations have steadily expanded the concept of "artificial" so as to include many natural substances. Unfortunately, and as a result of the inevitable confusion, the few private rulings on artificial baits which the Service has made available for public inspection have been inconsistent with the public rulings and with each other.

By way of a brief example, Mr. Chairman, we offer the following two illustrations of the seeming inconsistencies referred to above.

> 1. Rev. Rul. 71-321 - "Miniature marshmellows colored with dye and covered with a thin coating of oil derived from salmon roe." Held: taxable.
>
> Pvt. Ruling Doc. 5270000002A - "Miniature [deleted] similar to those sold in grocery stores as an item of food for human consumption. They are covered with a dye, reddish in color, and are coated with a thin coating of a liquid derived from salmon roe." Held: not taxable (1968).
>
> 2. Pvt. Ruling Doc. 7837013 "...swiss cheese, cheddar cheese, and blood meal. Midland compound is added to this mixture as a binding agent." Held: taxable (June, 1978).
>
> Pvt. Ruling Doc. 7940058 - "The bait is made from chicken blood... and is manufactured

> by a special process [deleted - which evidently binds the blood into patties]. The blood is packaged in patties ready for sale." Held: not taxable (July, 1979).

Even for a lawyer, it is difficult to harmonize these rulings. The average taxpayer, especially the small unsophisticated entrepeneur or proprietor of a family business, may not comprehend the fine distinctions drawn by the Internal Revenue Service. Likewise, the plain words which Congress used in the statute - "artificial bait" - do not give the taxpayer the slightest hint that they mean anything other than what the ordinary layman would take them to mean: a bait composed of man-made materials.

I would emphasize, Mr. Chairman, that the intended purpose and effect of S.2179 is not to change the law, but rather to ensure that the words of the statute are not interpreted to mean something quite different from their commonly accepted meaning. In addition to adding technical precision and consistency to the statute, we believe S.2179 would provide for sounder administration of this provision of the excise tax law as well. The administration of the tax on artificial baits would be improved and made more equitable in two major respects.

First, the bill would provide the affected taxpayers with more certainty as to their tax liability. It would do this by providing a logical, objective meaning to the term "artificial bait" that could be readily understood by taxpayers and revenue agents alike. In stating that this would improve the administration of this section of the Code, I would call the Committee's attention to the statement of policy made by the House Ways and Means Committee when it proposed the present statutory scheme of the excise tax in 1932. The Committee stated that a general manufacturer's excise tax must meet six fundamental tests, and one of the first was certainty as to tax liability. The Committee stated:

> It is essential that the persons who will be called upon to make returns and pay the tax to the Government must know, in advance of the sale, whether the sale is taxable and the amount of the tax liability. Having ascertained the taxability of the sale and the basis upon which the amount of tax is to be computed, they must be able to rely upon the determination. Retroactive imposition of the tax, or change in the method by which the tax is computed, necessarily results in hardship and dissatisfaction, which in turn will bring about the breakdown of the tax. H. Rept. No.708, 77th Cong., 1st Sess., p.32 (1932).

As the framers of the excise tax could clearly foresee, uncertainty could result in the highly undesirable, and potentially ruinous, retroactive imposition of the tax.* In the case with which I am most familiar, the matter involving the Don Rich Company, that is precisely what has happened. The company requested that the Assistant Commissioner (Technical) of the Internal Revenue Service use his discretionary authority under section 7805(b) of the Code to limit the retroactive effect of the Technical Advice given with respect to "Zeke's Floatin' Bait." As grounds for this request, the company contended that the IRS's ruling constituted a change in position, based on oral advice given by the Service that the bait was not taxable, and in later reliance on Rev. Rul. 71-321 which strongly inferred that a natural bait is taxable only if it is made to resemble some natural prey or other substance considered attractive to fish. The company also contended that the retroactive liability (which it estimated at between four and five times the company's net worth) would result in immediate bankruptcy, whereas prospective application of the tax would enable the company actually to pay the excise tax, which goes into the Dingell Fund for public conservation purposes. The requested relief was denied. I mention this particular proceeding, Mr. Chairman, only to illustrate the harshness of a retroactive tax when the taxpayer has been genuinely uncertain as to his liability, and that the threat of retroactivity is not as remote as one might think.

The second way in which S.2179 would improve the administration of the tax on artificial baits is that the bill provides for a more uniform application of the tax. Uniformity was another sine qua non to the proper administration of the excise tax cited by the framers of the manufacturer's excise tax:

> "It is of utmost importance that the tax be imposed and administered uniformly and without discrimination. Every member of a competitive group must pay upon substantially the same basis as all his competitors, even though his sales methods may differ." H. Rept. No.708, 77th Cong., 1st Sess., p.32 (1932).

S.2179 would promote uniformity by superceding the inconsistent rulings which have been issued in connection with natural baits (several of which are noted above). Furthermore, one of the leading natural packaged baits which is sold in bait shops nationwide is a certain brand of processed cheese, which is edible and can be found in any grocery store. It is the biggest single competitor, by far, of Zeke's Floatin' Bait, and is of course not subject to the excise tax nor, as a food for humans, to most state sales taxes. The discriminatory competitive impact of the tax is illustrated by the fact that Don Rich Company does not pass the tax along to its customers in order to keep the price low. The cheese contains artificial chemicals and coloring, and the fishbait contains the same reconstituted animal matter as is contained in the cheese, in roughly the same proportions. Yet one is "artificial" and taxable, and the other is not under current rulings. S.2179 would eliminate this problem and cause similar competing products to be taxed uniformly. The bill would not affect the tax on other forms of bait or fishing equipment.

---

*/ For an enlightening discussion concerning the retroactive assessment of an excise tax as to previous sales in which the tax was either passed on or not paid in good faith, see the comments of Senator Watson in the Congressional Record, p.8116 et.seq., (May 8, 1924).

In conclusion, S.2179 would clarify the expansive and, we believe, statutorily unsupported definition of the term "artificial bait" that has evolved through the Treasury's rulings and regulations over the past twenty years. The bill would also promote the sound and equitable administration of the excise tax law as contemplated by its framers, at little cost to the government. The bill would also lessen the burden and cost of compliance with the law by taxpayers. My client, for example, already has paid for four years of legal fees and three cross-country trips to Washington to determine whether its cheese bait is artificial. It even contacted an ichthyologist at UCLA for an opinion on whether the garlic and banana-scented varieties of Zeke's Floatin' Bait were "considered more attractive to fish" than plain cheese (he said they were not). This unreasonable cost of compliance would hopefully be reduced by the bill for other taxpayers in future years. For these reasons, I urge the favorable consideration of S.2179.

I am grateful for this opportunity to express my views and would be happy to respond to any questions which your Committee or staff may have.

STATEMENT OF CONGRESSMAN JERRY LEWIS
ON H.R. 7172

Mr. Chairman and Members of the Subcommittee, I appreciate this opportunity to submit a statement in support of the bill H.R. 7172. I am a sponsor of identical legislation, H.R. 6346. As you know, this is a simple proposal, aimed at clarifying the intent of Section 4161 of the Tax Code which now reads.

> "There is hereby imposed upon the sale of fishing rods, creels, reels and artificial lures, baits, and flies (including parts or accessories of such articles sold on or in connection therewith, or with the sale thereof) by the manufacturer, producer, or importer a tax equivalent to 10 percent of the price for which so sold."

I would like to briefly explain my personal involvement with this legislation. Late last year, Mr. Frank Witteman, a constituent of mine, visited Washington and discussed with me his current and potential difficulties which are created by this Section. Mr. Witteman is an example of the embodiment of the American dream--a man who successfully invents and perfects a marketable product himself, patents that product and develops a growing demand for it. He is the kind of man who typifies what has made our nation great--the private entrepreneur who through his own effort develops a commercially viable product and who then markets that product to willing consumers.

In Mr. Witteman's case, back in 1966 he first developed a fish bait, originally intended for his own recreational use, working in his own kitchen. Subsequently his fishing cronies became aware of the superior qualities of this substance (which consists solely of material edible by fish) and began to request that he supply them as well. The product was patented and, subsequently in 1969, Mr. Witteman established his own company, Don Rich, Incorporated, to manufacture Zeke's Floating Bait for commercial sales.

Regrettably, in this instance (and I am sure in many others) subsequent activities by the federal government seem to have the effect of destroying this most worthwhile activity. Like many private citizens, Mr. Witteman was not accustomed to the problems which can be encountered when dealing with the nit-picking and burdensome regulations of the federal government.

When attending a trade show, back in 1970, Mr. Witteman first became aware that there was a possibility that Zeke's Floating Bait sales would be subject to a 10% excise tax. Being a prudent businessman, he contacted his attorney and requested that this point be clarified. That gentlemen contacted appropriate officials in the Excise Tax Section of the Los Angeles District Office of the IRS and was verbally advised that the bait was not subject to taxation. The attorney so advised Mr. Witteman and both then regarded the question as resolved. In fact, Don Rich, Incorporated, was subject to two audits subsequent to that conversation and the excise tax question was not raised during either of these.

Recently, however, representatives of the IRS have contacted Mr. Witteman and have advised him that notwithstanding the verbal opinion obtained by his attorney back in 1971, Zeke's Floating Bait is subject to the excise tax both prospectively and retrospectively. While the final audit of the amount is not completed and Mr. Witteman is contestin the matter in Tax Court, there are indications the final amount due may well exceed $300,000. Both you and I recognize the kind of disaster this potential debt would represent for a small manufacturing concern.

Mr. Chairman, I do not ask that this panel deal with Mr. Witteman's past tax liabilities--that is a question which he and his representatives will resolve through the established processes. I do ask that this Section of the Tax Code be clarified for the future. In any reasonable definition of the term, Zeke's Floating Bait is not artificial--it is composed of materials which can be ingested by fish and is biodegradable. In fact, Zeke's main competitor is processed cheese products (often stocked in bait shops) on which no excise tax is levied. If we do not amend Section 4161 in this manner, the future of Don Rich, Incorporated, is much in doubt. Specifically, this would mean of loss of eleven jobs in my District and the loss of up to $100,000 a year in lost sales tax revenues by the State of California. More generally, though, I fear that it would reflect the unwillingness of the federal government to enact sensible and equitable tax laws designed to foster the creation and expansion of private business within our nation. Frank Witteman and Zeke's Floating Bait are only one of many examples of this occurence.

Mr. Chairman and Members of the Subcommittee, I urge that you favorably report H.R. 7172 and thank you for this opportunity to make my position known.

STATEMENT ON S. 2179 (H.R. 7172)

OF

HONORABLE JOHN H. ROUSSELOT

26th DISTRICT, CALIFORNIA

Mr. Chairman:

My appearance here is to urge favorable action on S. 2179. This proposal is in behalf of a small business in my State of California. Mr. Frank Witteman is the head of the Don Rich Company for whom this legislation was introduced. Mr. Witteman will present to this Committee the detailed facts that gave rise for the request. I shall not repeat those details.

Mr. Chairman, the enactment of this legislation is very important. The story of Mr. Witteman and the business he built is one of the inspiring stories of our private enterprise system. Mr. Witteman manufactures a fishing bait called "Zeke's Floating Bait." This business was started in the kitchen of Mr. Witteman's home. Later he manufactured this fish bait in his garage. Now he operates in a small factory and he has gone from one employee to eleven.

Zeke's Floating Bait is made of natural substances. It is edible and can be ingested by fish. The IRS, however, is endeavoring to collect a ten percent excise tax which is imposed on artificial bait, claiming Mr. Witteman's bait is not composed of natural substances.

Mr. Witteman's business prospered. Years later, the IRS descended upon him with a claim that the tax on artificial bait applies to his product. They want to collect this tax retroactively. Mr. Witteman, in my opinion, rightly contends that his product is not artificial and therefore not subject to the tax. I believe that the Congress should step in and save this small business from such unfair treatment.

The manufacture and sale of fishing bait is highly competitive. Unless Mr. Witteman can obtain some relief from the Congress there is considerable danger that he will have to terminate his business.

Throughout my service in Congress I have spent a great deal of time in defending and promoting small business. In this case we have a successful small business. It exists because of the knowledge and effort and risk-taking of an individual. Because of the success of this venture jobs were provided for nearly a dozen of the citizens of my state.

Mr. Chairman, I trust that you will quickly and favorably consider this proposal. It is the function and responsibility of government not only to refrain from harming the small businesses but to create an environment that encourages and enhances and protects small businesses.

Accounts of the creation of job producing businesses by far-sighted individuals such as Mr. Witteman come to our attention these days far too infrequently. Congress should see to it that such enterprises are encouraged. It is still true "the power to tax is the power to destroy."

I want to thank you for the opportunity of appearing here.

STATEMENT OF SENATOR S. I. HAYAKAWA

Mr. Chairman:

I am very happy to appear before you today to introduce Mr. Frank Witteman, who is immediately on my left here, president of the Don Rich Co. of La Canada, California.

Mr. Witteman is confronted with a difficult tax problem involving the excise tax on artificial bait under section 4161 of the Internal Revenue Code. Senator Cranston has joined me in introducing S. 2179, which is before your committee today, to define the term artificial bait for the purposes of this section of the code.

Being an amateur fisherman, and thinking of fishing, and the choice of bait and so on, solely in connection with recreation, it really startled me to find myself in this august body of the U.S. Senate arguing about the different kinds of fish bait, but the mysteries of bureaucracy are past all understanding. Mr. Witteman is convinced, and I concur with him, that it was the intent of Congress to tax only artificial bait such as lures and flies which cannot be ingested by fish. Unfortunately, the Internal Revenue Service has taken the position that Mr. Witteman's bait, which is 95-percent edible plant and animal matter-milk products among other things-is "an artificial bait" and therefore subject to the excise tas. It seems to me that this bait should no more be subject to the excise tax than say beetles or fishworms or frogs.

Since the direct competitors with the Don Rich Co.'s bait are cheeses and other foodstuffs which are not subject to the tax, any excise tax would put the Don Rich Co. out of competition and out of business.

Therefore, I have brought this matter up before this committee. I think a real injustice is done to Mr. Witteman by this particular bureaucratic decision. I would like then to turn the microphone over to Mr. Witteman. Thank you, Mr. Chairman.

STATEMENT OF SENATOR ALAN CRANSTON
BEFORE THE SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT GENERALLY
COMMITTEE ON FINANCE
APRIL 25, 1980

Mr. Chairman:

.......I am a co-sponsor, with my colleague from California, Senator Hayakawa, of S. 2179, a bill to clarify section 416(a) of the Internal Revenue Code relating to the excise tax on artificial bait.

This is a bill offered largely for the relief of the Don Rich Company, Incorporated, of Redlands, California, which manufactures a product known as "Zeke's Floatin' Bait." The bill clarifies the definition of artificial bait so that it cannot be applied to a product, such as the Don Rich Company's product, which is a natural fish food treated with flavorings and additivies to make it more attractive to fish. The subcommittee will be hearing from Mr. Frank Witteman, president of the company. I simply wish to urge the subcommittee to give this bill sympathetic consideration. Thank you very much.

Chairman STARK. Senator, can you tell me without divulging trade secrets, what is in this?

Mr. CURTIS. There are some additives there that make it float. Now keep in mind that everything in the grocery store has additives.

Chairman STARK. I have got that in mind. Do you have a list of what is in here?

Mr. CURTIS. That is a trade secret. I don't know myself.

Chairman STARK. A U.S. Patent 3,359,114 is on it. Would that tell me what is in here?

Mr. CURTIS. This is Mr. J. B. Wilson, attorney for Mr. Witteman.

Mr. WILSON. Mr. Chairman, the additives in this product are a small percentage of its weight, less than 10 percent. Some of the versions of this product marketed to fishermen have some scent or coloring added to attract the fancy of the fisherman, and all of them, all of the versions, have a small amount of powder added to it which lessens the density of the product, so as to make it buoyant. But the percentage of these ingredients total is not a great deal more than would be found in regular processed cheese spread.

Chairman STARK. I am aware that processed cheese is colored. I don't know that it is scented, and I suppose it has additives that keep it from spoiling. It would seem to me that the scent and the coloring are natural. If you took Velveeta and put it in this jar, and called it Zeke's Floating Bait, wouldn't you be subject to the excise tax?

Mr. WILSON. Yes.

Chairman STARK. You would?

Mr. WILSON. Well, you will have to ask the Treasury that.

Chairman STARK. It is your understanding?

Mr. WILSON. The original formula bait was regular cheese.

Chairman STARK. If I just went on to purchase processed cheese, and put it in a bottle and called it Pete's Floating Bait, I would have to pay a 10-percent excise tax; but if I packaged it as processed cheese and then put a sign up at the counter display saying this would be handy for catching bass, I wouldn't. Is that where we are at?

Mr. CURTIS. Mr. Chairman, very much so. Now the Treasury has attempted to impose a tax on all bait. I hold in my hand the case in the Court of Claims just decided in October 1980. In that case, it is the Nelson Buck Creamery. This creamery sold a cheese called Gold Nugget Processed Cheese. They found that fishermen liked it, and fishermen bought it. So they repackaged it in a package that would fit into a tackle box. Using the language of the court here, they repackaged it and renamed it. The Treasury, the IRS, imposed the tax.

The Court of Claims, in a very emphatic opinion, not only decided in favor of the taxpayer but ridicules the reasoning of the Government. We think that this case should be followed, and we wouldn't have to be here, but under the circumstances we need the legislation. We need a definition of what "artificial" is. The law does not tax all bait; it taxes artificial bait. I believe, in fairness to future taxpayers and to everybody else, that we should say what artificial is.

We believe that if it is substantially all plant and animal food that can be ingested by the fish, that it is certainly not artificial.

Chairman STARK. I am not sure that it is this committee's position to be voting on whether or not Zeke's Floating Bait is artificial or natural, particularly in the absence of a formula. That seems to me to be a chemist's or a biologist's decision. Since to the extent that it is an empirical decision, I think the law is clear.

If you are packaging a cheese product that could otherwise be considered natural cheese under the same definition used in the supermarket, I think you are right. But it is a little bit difficult. I am sure that the trade secrets, if they are not disclosed in the patent, are indeed a valuable and important part of the business.

It seems to me the only way you can prove that is to come forward with the formula. That, in fact, opens you up to a lot of competition, and I guess the decision is: Is that worth 10 percent?

I don't know how else to———

Mr. CURTIS. I agree with the chairman that it is an administrative decision, but I think also in this particular case it is the responsibility of the writers of legislation to provide some guidelines. This legislation does not say please take the tax off of Zeke's Floating Bait. It gives a guideline, a definition of what is artificial. That if it contains 85 percent of plant and animal food, it is not artificial.

Chairman STARK. But let's just suppose that I manufactured a little plastic, colored bait like a Basserino. Then with modern technology I was able to manufacture it to be very light. If I stuffed it with cheese, and kept it air tight so that cheese didn't smell after a couple of weeks, I could then avoid the 10 percent excise tax. Then I would run back to my artificial lure company, on the completion of the passage of 617, and start to drill a hole in the middle of my lures and stuff them with cheese.

Mr. CURTIS. You are speaking of a lure that resembled something.

Chairman STARK. I suppose there is a CPA or a tax person that could design something that could qualify.

Mr. CURTIS. We have no objection if you see fit to add that it has to be sold in jars or boxes or what not. But certainly, Mr. Chairman, if it is the will of the Congress to tax bait that is not artificial, then it should be enacted into law. But here is an individual that knew that all the State regulations comfirm that it is not artificial bait. A fisherman would be arrested fishing with this at a place where it was restricted to artificial bait. He went to the IRS; they told him it wasn't, or his lawyer did.

Chairman STARK. Mr. Duncan.

Mr. DUNCAN. Did I understand that you said that IRS actually approved this at one time?

Mr. CURTIS. No, I want to make this clear. In retrospect, a mistake was made on the part of the taxpayer. You see, he set up this business in his kitchen. He heard about a tax, so he had his local lawyer inquire about it. He inquired of the nearest IRS office. In oral conversation they said, "No, that is not taxable." Five years later they came back with a claim for taxes. The position of the Treasury runs absolutely counter to the decision of the Court of Claims of last October.

Mr. DUNCAN. I agree with you that they should follow the Court of Claims.

Mr. CURTIS. I want to thank the chairman and Mr. Duncan for your patience and understanding of this issue. Thank you very much.

Chairman STARK. Thank you very much.

Our next witness will be Fred J. Gentile, vice president and comptroller of the Brooklyn Union Gas Co. He is accompanied by Mr. Harold Heltzer, tax counsel. This is only natural gas, no artificial gas.

STATEMENT OF FRED J. GENTILE, VICE PRESIDENT AND COMPTROLLER, BROOKLYN UNION GAS CO., ACCOMPANIED BY HAROLD J. HELTZER, TAX COUNSEL

Mr. GENTILE. This is natural and some methane gas.

Chairman STARK. We have your full, prepared statements, which will appear in the record in their entirety, and if you would care to summarize your testimony for the committee, it would be appreciated. You may proceed in any fashion you see fit.

I wanted to also thank our colleague, Congressman Rangel, who is the author of this legislation; he had hoped to be here, but other commitments kept him from getting here on time for this early Monday morning hearing, and he asked me to extend a welcome to you.

Proceed.

Mr. GENTILE. Mr. Chairman and members of the subcommittee, Mr. Duncan, my name is Fred Gentile. I was vice president and was promoted to chief accounting officer on November 1981 of the Brooklyn Union Gas Co. In that capacity I am very pleased to have the opportunity today to present the views of Brooklyn Union Gas with respect to H.R. 4917, legislation intended to clarify the definition of the term "local furnishing" contained in section 103(b)(4)(E) of the Internal Revenue Code of 1954, as amended.

H.R. 4917 would modify the definition of a facility for the "local furnishing" of gas to include a facility for the furnishing of gas which is part of a system which provides service to an area no larger than a city and one contiguous county.

Brooklyn Union fully supports and urges the enactment of H.R. 4917.

Briefly by way of background, Brooklyn Union furnishes and distributes natural gas at retail exclusively in three counties, all of which are within New York City. We serve approximately 4 million New York City residents in addition to small commercial and industrial businesses. The question here is the definition to be given to the word "local" contained in section 103(b)(4)(E). That section allows the issuance of tax-exempt bonds to finance the contruction of facilities for the local furnishing of electric energy or gas.

Since 1968 the term "local furnishing" was interpreted by the Treasury Department to have the same meaning for both electric energy and gas. Essentially, under the Treasury regulations the term "local furnishing"; was defined as a service area no greater than two contiguous counties. However, where the service area consisted of a city, the local furnishing requirement could not be satisfied if the city consisted of more than two counties.

The geographical size of the city or the county was not taken into account. Essentially, whether the local furnishing tests could be satisfied in the case of a city was dependent solely upon the political structure of the city. If the city had more than two counties, such as the case with New York City, the test could not be met.

This interpretation distorted the basic notion of the word "local." In the Revenue Act of 1978, both Congress—and I might add that the Treasury Department—fully supported and concluded that local should not be defined in such a distorted manner, but rather the term "local," if it means anything, should at least include a single city. But, unfortunately, the clarification appears to have been limited only to electric energy.

H.R. 4917 is intended to cure this oversight by simply extending the clarifying definition of local furnishing by the Revenue Act of 1978 to the local furnishing of gas, and once again the term "local" would be interpreted the same way for both electric energy and gas.

It should be noted that the provisions of House bill 4917 are included in tax legislation adopted by the Senate Finance Committee on July 2, 1982. The Treasury Department has recognized that the failure to afford gas distribution the same treatment as it afforded to electric distribution may result in inequity. Treasury did not oppose the Senate Finance Committee, and today, I might add, Treasury also testified to the unfairness toward New York City.

It is a well known fact that the residents of New York City pay the highest gas and electric rates in the Nation, which rates are rapidly escalating today.

Mr. Chairman, the enactment of House bill 4917 would substantially assist Brooklyn Union in its efforts to tap potential methane gas in the various landfills located in its service area. Brooklyn

Union has for several years been interested in developing to its fullest extent the use of these landfills within New York City as a potential source of energy.

Studies made by Brooklyn Union show that one such landfill in New York City, once tapped, has the potential of producing enough gas to heat approximately 10,000 homes annually, and thereby reduce the need of imported oil by approximately 600 barrels a day.

Mr. Chairman, any benefit Brooklyn Union receives from H.R. 4917 is passed on to its customers due to lower costs of financing to be reflected in its gas rates.

In conclusion, Mr. Chairman, Brooklyn Union fully supports and strongly urges the enactment of H.R. 4917. With the adoption of just two words the bill corrects what can be described as an oversight in a prior amendment. It also substantially advances our national energy goals.

Mr. Chairman, we request that our complete statement in support of the enactment of House bill 4917 be entered into the record. That ends my discussion. Thank you.

[The prepared statement follows:]

STATEMENT OF FRED J. GENTILE, VICE PRESIDENT AND CHIEF ACCOUNTING OFFICER, BROOKLYN UNION GAS CO.

SUMMARY

Section 103(b)(4) of the Internal Revenue Code provides that State and local governments may issue tax-exempt industrial development bonds to finance "facilities for the local furnishing of electric energy or gas." In order to qualify under existing Treasury Regulations, the facility may not serve an area larger than two contiguous counties. A city that was an independent political entity was treated as a county for purposes of this definition, but other cities were not.

This definition of "local furnishing" of electric energy or gas created an apparently unforeseen problem for New York City. Because of its unique political structure, New York City is the one city in the United States that cannot issue tax-free industrial development bonds for city-wide gas furnishing facilities. This result occurs because New York City consists of five boroughs, each of which is a separate county. Since New York City contains five counties, it could not directly qualify under the "two contiguous county" rule.

Brooklyn Union Gas Company is a regulated public utility which furnishes and distributes natural gas at the retail level within Brooklyn, Staten Island, and most of Queens. The Company is actively involved in efforts to develop new domestic sources of energy; for example, the capture and use of methane that is naturally produced in landfills. Unfortunately, such projects are hampered by New York City's inability to issue tax-exempt industrial development bonds to help finance such gas-furnishing efforts.

New York City's problem was partially rectified by the Revenue Act of 1978. That legislation permitted New York City to meet the "local furnishing" test for purposes of electric energy facilities by including facilities which provide service to an area no larger than a city and one contiguous county. However, this amendment was not extended to the "local furnishing" of gas.

H.R. 4917 would modify the definition of a facility for the "local furnishing" of gas to include a facility for the furnishing of gas which is part of a system which provides service to an area no larger than a city and one contiguous county. It would correct the oversight contained in the Revenue Act of 1978 and eliminate the inconsistent treatment between gas and electric energy facilities so that once again gas and electric facilities would be treated alike for purposes of the "local furnishing" requirement. Any city, plus a contiguous county, would be treated as constituting a "local furnishing" area for gas, as well as electric energy, facilities. As a result, New York City would be able to issue tax-exempt bonds to help finance local facilities for the furnishing of both gas and electric energy.

The "local furnishing" requirement under current Treasury Regulations is based, in large part, on the particular political structure or arrangement of a local jurisdiction, and not on the geographic size of the area serviced by the facilities or the geographic size of the local jurisdiction. Under the circumstances, the current requirements for designation as a "local furnishing" area are arbitrary and distort common sense notions of the meaning of "local." It makes little or no sense for two large and sparsely-populated contiguous rural counties to be deemed to constitute a local service area, while New York City, with its five densely-populated counties, is not. Congress has made its purpose clear with respect to facilities for the furnishing of electric energy and the same rule should apply in connection with facilities for the furnishing of gas. Indeed, the Treasury Department has recognized that the "local furnishing" requirement should be applied in a fair and consistent manner with respect to all local jurisdictions, regardless of their political structures, and supported the amendment contained in the Revenue Act of 1978.

On July 2, 1982, a provision identical to that in H.R. 4917 was adopted by the Senate Finance Committee in the course of its actions on a tax legislative package. The Treasury Department recognized the inequitable result that may be caused under current law and did not oppose this action.

For these reasons, we urge that the industrial development bond provisions be amended to clarify the definition of "local furnishing" in order to rectify the oversight contained in the Revenue Act of 1978, and allow the City of New York to issue tax-free industrial development bonds for city-wide gas furnishing facilities.

We support H.R. 4917.

STATEMENT

Mr. Chairman and members of the subcommittee, my name is Fred J. Gentile. I am Vice-President and Chief Accounting Officer of The Brooklyn Union Gas Company. In that capacity, I am very pleased to have the opportunity today to present the views of Brooklyn Union with respect to H.R. 4917, legislation intended to clarify the definition of the term "local furnishing" contained in Section 103(b)(4)(E) of the Internal Revenue Code of 1954, as amended. H.R. 4917 would modify the definition of a facility for the "local furnishing" of gas to include a facility for the furnishing of gas which is part of a system which provides service to an area no larger than a city and one contiguous county.

Brooklyn Union fully supports and urges the enactment of H.R. 4917.

This precise amendment was included in the Revenue Act of 1978 (P.L. 95-600) as applied to the local furnishing of electric energy, but through an oversight, was not extended to the local furnishing of *gas*. H.R. 4917 corrects this oversight. The effect of H.R. 4917 is simply to clarify and conform the definition of the term "local furnishing" contained in Section 103(b)(4)(E) in order that the term once again will have the same meaning when referring to both the local furnishing of electric energy as well as gas.

BACKGROUND

The Brooklyn Union Gas Company is a regulated public utility which furnishes and distributes natural gas at the retail level exclusively within portions of New York City. Its relatively small service area consists of 187 square miles, which encompasses the Boroughs of Brooklyn, Staten Island and a portion of the Borough of Queens. (The corresponding counties are Kings, Richmond and Queens, respectively.) Brooklyn Union Gas Company serves approximately 4,000,000 residents within these three boroughs of New York City. About ninety-seven percent of its customers are residential users, while the balance are primarily small or medium-sized commercial and industrial users.

The Company is actively involved in efforts to develop new domestic sources of energy. One important area of interest to municipalities throughout the nation is the capture and use of methane that is naturally produced in landfills. Natural gas is composed primarily of methane and carbon dioxide, and is produced in landfills through a process known as anaerobic decomposition. Because it is lighter than air, the gas produced in this manner now simply rises and escapes into the atmosphere.

For several years, Brooklyn Union Gas Company has been interested in developing, to the fullest extent possible, its ability to use landfills within New York City to produce new sources of energy for local use. Unfortunately, this and similar projects are hampered by New York City's inability to issue tax-exempt industrial development bonds to help finance such efforts. Indeed, the absence of such a financing mechanism simply causes more expensive financing to be used and, thus, results in unnecessarily higher gas prices to customers.

DISCUSSION

Section 103 of the Internal Revenue Code provides generally that interest earned on obligations issued by a State or local government (or political subdivisions thereof) is exempt from Federal income tax. However, since 1968, a tax exemption has been denied to industrial development bonds, the proceeds of which are used by a taxpaying enterprise in its trade or business, except where the proceeds of the bonds are used for specific exempt purposes. Included within these exempt purposes are industrial development bonds issued in connection with "facilities for the local furnishing of electric energy or gas." (Section 103(b)(4)(E)).

Neither the Internal Revenue Code nor the legislative history of this provision defines "local furnishing" for purposes of Section 103(b)(4)(E). However, it is apparent that the statute was intended to have the same meaning for purposes of the "local furnishing" of both gas and electric energy facilities. Treasury Regulations promulgated under Section 103 took that approach, and defined the term in an identical manner for purposes of the local furnishing of both electric energy and gas. Under the Treasury Regulations, in order to qualify as a facility for the "local furnishing of electric energy or gas," the facility could serve an area no larger than two contiguous counties (Treasury Regulations § 1.103-8(f)(2)(iii)(d)):

"[T]he term 'facilities for the local furnishing of electric energy or gas' means property which * * * [i]s part of a system providing service to the general populace of one or more communities or municipalities, but in no event more than 2 contiguous counties (or a political equivalent) whether or not such counties are located in one state."

In addition, the Treasury Regulations provided that a city would be treated as a county for purposes of determining an area for "local furnishing" only if it were an independent political entity (Treasury Regulations § 1.103-8(f)(2)(iii)):

"For purposes of [these Treasury Regulations], a city which is not within, or does not consist of, one or more counties (or a political equivalent) shall be treated as a county (or a political equivalent)."

Under this Treasury Regulation, the "local furnishing" requirement was the same for both electric energy and gas, and could be satisfied if the service area consisted of one city (regardless of geographic size) which was an independent political entity. As a result, a city which was an independent political entity would then be able to combine with one contiguous county to constitute a "local furnishing" area.

However, where the service area included a city which consisted of more than two counties (such as New York City) the "local furnishing" requirement could not be satisfied for either electric energy or gas. As a result, under this "no more than two contiguous counties" rule, the "local furnishing" requirement could not be satisfied in certain situations, even where the service area of the facilities consisted of a single city.

One unintended result of the Treasury Regulations was that New York City became the only city in the country that could not meet the "local furnishing" test for the purpose of issuing tax-exempt industrial development bonds for either electric energy or gas. This result occurs because, under its unique political structure, New York City consists of five boroughs (Brooklyn, Staten Island, Queens, Bronx, and Manhattan), each of which is a separate county. Since New York City contains five counties, it could not directly qualify under the "two contiguous county" rule.

In sum, the "local furnishing" requirement under the Treasury Regulations was based, in large part, on the particular political structure or arrangement of a local jurisdiction, and not on the geographic size of the area serviced by the facilities or the geographic size of the local jurisdiction. Under these circumstances, it is apparent that the current requirements for designation as a "local furnishing" area are arbitrary and distort common sense notions of the meaning of "local." It makes little or no sense for two large and sparsely-populated contiguous rural counties to be deemed to constitute a local service area, while New York City, with its five densely-populated counties, is not.

Many municipalities are also much more sprawling than New York City and yet nevertheless meet the "local furnishing" requirements. Jacksonville, Florida and Oklahoma City, Oklahoma, for example, would both qualify as "local" areas, even though they contain 766 and 636 square miles, respectively. There is simply no reason for New York City (which consists of only 300 square miles) to be treated differently.

In addition, it is anomalous that Federal tax provisions should discriminate against municipalities on the basis of differing political arrangements. In an era of increasing emphasis on local autonomy, it is ironic that, as a matter of Federal law, New York City cannot finance the development of gas facilities in the same manner as every other city in the country, merely because it is organized in a manner that maximizes local self-government.

One specific example illustrates this discrimination. In 1974, Brooklyn Union Gas Company constructed a substitute natural gas plant at a capital cost of $50 million. New York City was unable to utilize tax-exempt bond financing because of the limitations of the two contiguous county rule. However, in this same year a similar substitute natural gas plant was constructed in Illinois at a capital cost in excess of $75 million. The financial benefits of tax-exempt financing were utilized in connection with the construction of this latter facility, since the two contiguous county rule was met. There is no justification for this inconsistent treatment.

H.R. 4917 would encourage gas development and help reduce the nation's dependence on imported oil. For several years, Brooklyn Union Gas Company has been interested in developing, to the fullest extent, its use of landfills within New York City as a potential source of energy. However, because of the inability of New York City to issue tax-exempt industrial development bonds for gas facilities, Brooklyn Union Gas Company may be unable to proceed with the potentially promising development of methane gas from landfills. The Company's studies indicated that landfills in New York City have the potential of producing enough gas to heat up to approximately 40,000 homes annually. This would reduce the need to import about 2,400 barrels of oil per day. Full development of the methane from the major landfill sites in Brooklyn Union Gas Company's service area could supply as much as five percent of its customers' current gas requirements. Morever, by encouraging innovative gas development, H.R. 4917 would help reduce the long-term escalation in gas rates in New York City, where utility rates are among the highest in the nation.

The anomalous situation resulting from the interpretation of the term "local furnishing" contained in the Treasury Regulations was partially remedied in the Revenue Act of 1978, which allowed New York City to meet the "local furnishing" test for purposes of electric energy facilities (P.L. 95-600, Section 332). Specifically, Section 103 (b)(4) was amended to provide that:

"[T]he local furnishing of electric energy from a facility shall include furnishing solely within the area consisting of a city and 1 contiguous county."

Through this legislation, both Congress and the Treasury Department recognized that the proper test for determining whether the "local furnishing" requirement is met should not depend on the particular political arrangement of a city. Rather, both believed that the "local furnishing" requirement should be applied in a fair and consistent manner with respect to all local jurisdictions, regardless of their political structures. Indeed, the Treasury Department set forth this position in a letter to Senator Moynihan from the Assistant Secretary for Tax Policy (The Honorable Donald C. Lubick):

"[s]ince a city is a single governmental unit, even if it embraces more than one county, the requisite local character of the furnishing is as much met by the standard you propose as by the current two-county standard. For reasons of consistency in the treatment of local jurisdictions for purposes of the 'local furnishing' test, we therefore support your amendment."

Accordingly, as part of the Revenue Act of 1978, the definition of the term "local furnishing" was clarified to include a service area consisting of no more than one city and one contiguous county. However, the clarification was limited only to the local furnishing of electric energy, and did not include the local furnishing of gas, even though the term "local furnishing" had always, prior to that time, been given the same interpretation by the Treasury Department for both electric energy and gas.

H.R. 4917 would correct this oversight and eliminate the inconsistent treatment between gas and electric energy facilities by amending Section 103(b)(4) so that once again gas and electric facilities would be treated as constituting a "local furnishing" area for gas, as well as electric energy, facilities. As a result, New York City would be able to issue tax-exempt bonds to help finance local facilities for the furnishing of both gas and electric energy.

SENATE FINANCE COMMITTEE ACTION

On July 2, 1982, a provision, identical to that in H.R. 4917 was adopted by the Senate Finance Committee in the course of its actions on a tax legislative package. The Treasury Department recognized the inequitable result which may be caused under current law did not oppose this action.

CONCLUSION

H.R. 4917 would further the Congressional intent and clarify the definition of the term "local furnishing" contained in Section 103(b)(4)(E) of the Code. H.R. 4917 would cure an oversight contained in the Revenue Act of 1978 and would allow The Brooklyn Union Gas Company to fully develop landfills located in its service area as a source of additional gas, consistent with the national objectives of greater dependence on domestic and alternative sources of energy. It would allow New York City to issue tax-exempt industrial development bonds to help finance gas furnishing facilities to the same extent as permitted in every other city in the United States. We urge your support for H.R. 4917 which would permit the issuance of industrial development bonds to help finance local gas furnishing facilities.

Chairman STARK. Thank you very much, Mr. Gentile.

In the revenue estimates, this deals with industrial development bonds which are issued or you propose to issue, is that correct?

Mr. GENTILE. We propose to issue.

Chairman STARK. How many?

Mr. GENTILE. Looking at the next 5 years, between utilities that operate in New York City for gas, we feel the revenue loss will be approximately in the neighborhood of less than $20 million.

Chairman STARK. But how much does Brooklyn Gas—in dollar amount, what would you have outstanding at the end of 5 years?

Mr. GENTILE. At the end of 5 years, our revenue loss——

Chairman STARK. No, the face value of the bonds.

Mr. GENTILE. The face value of the bonds of Brooklyn Union would be about $150 million. This assumes that we issued IDB's for 50 percent of our construction program.

Mr. HELTZER. That is projected.

Chairman STARK. That is projected, so that if the revenue loss were—what are you paying now, 12?

Mr. GENTILE. Our long-term debt can go for 16, single A. The margin could be 3 percent difference for IDB's, and this happened in 1974.

Chairman STARK. In other words, you would issue them now at 12, so we would lose 6 percent; the Treasury would lose 6 percent; right?

Mr. GENTILE. If it is 16, 3 percent would be down to 13. In 1978——

Chairman STARK. But our loss, what we would collect, if you are issuing at 16, we are collecting 8?

Mr. GENTILE. We have this problem.

Chairman STARK. That is $12 million per year?

Mr. GENTILE. Right.

Mr. HELTZER. There is an offset. The offset includes the fact that the expenses for the company won't be fully deductible at the higher interest rate.

Chairman STARK. And so it is 12 maximum?

Mr. HELTZER. The estimate for the next 5 years, somewhere around $15 million.

Chairman STARK. Is there any objection—and there is some question that this runs higher; they are running $8, $12, $15 billion a year by 1987—to make this a noncode amendment and specifying Brooklyn Union Gas? You don't care, do you?

Mr. GENTILE. No; the question here is that the current rate is 16 percent, but we are saying the average would be 12.

Chairman **Stark**. There is some objection to this in that it may blossom over into other companies and other uses. One of the ways that we can limit that is by making this a noncode amendment, which is specifically designed for you.

Mr. **Gentile**. There is no problem. In 1974, for your information, People's Gas of Chicago was able to build an SNG plant for $80 million and issued bonds for 6 percent. Brooklyn Union built an SNG plant for $50 million in 1974. We were not able to use IDB's, and we went to the market at over 9 percent. This is the inequity we had, and our ratepayers paid that extra cost.

Chairman **Stark**. Mr. Duncan.

Mr. **Duncan**. I have no questions. Thank you.

Chairman **Stark**. Gentlemen, thank you very much.

Our next witnesses will be a panel consisting of our colleague, the Hon. Ron de Lugo, the Delegate from the Virgin Islands; the Hon. Juan Luis, Governor of the Virgin Islands; and Mr. Neil Kimmelfield, the counsel from the Virgin Islands Trade and Economic Development Institute.

STATEMENT OF HON. RON de LUGO, A DELEGATE TO CONGRESS FROM THE VIRGIN ISLANDS

Mr. **de Lugo**. He is a good man.

Chairman **Stark**. I would like to welcome our colleagues, Mr. de Lugo. Would you like to introduce your fellow panelists?

Mr. **de Lugo**. Thank you very much, Mr. Chairman.

Chairman **Stark**. Proceed in whatever fashion you see fit.

Mr. **de Lugo**. It is good to be before the committee this morning, Mr. Chairman and Mr. Duncan. I have with me on my immediate right the Governor of the Virgin Islands, Gov. Juan Luis, and next to the Governor, Mr. Neil Kimmelfield, who is counsel to the Virgin Islands Trade and Economic Development Institute.

The Governor and Mr. Kimmelfield are joining with me in support of legislation before the committee this morning which is extremely important to the people of the Virgin Islands.

I listened with great interest to the testimony of Secretary Chapoton and had an opportunity to talk with him briefly after he testified before your committee. Before I get into my prepared statement, I would like to say that I would hope that Treasury would see its way clear to including the treaty countries in this legislation. I think that is reasonable.

Inclusion of the treaty countries is very important to the people of the U.S. Virgin Islands, and this is particularly true in view of the whole CBI question.

Mr. Chairman, the Virgin Islands has, of necessity, been sensitive through the years to the need to compensate for its insular location in its efforts to attract private industry. We have gone to great lengths to attract and retain business. With the numerous trade agreements the United States has entered into, however, the Virgin Islands is finding it increasingly difficult to compete for offshore business, a situation which will be exacerbated when the President's Caribbean Basin proposal is passed.

Many businesses have declined the Virgin Islands Government's efforts to get them to locate in the territory, citing the 30-percent withholding tax provision of the Internal Revenue Code of 1954 as their sole impediment. Local businesses claim that expansion is frustrated due to reluctance of mainland banks to lose 30-percent of their interest on loans to Virgin Islands taxes.

Apart from this impact on business investment, exclusion from mainland banks has effectively closed the secondary mortgage market to Virgin Islands financial institutions. The result has been not only to destroy most Virgin Islanders' hopes of owning their own homes, but a serious housing shortage in this U.S. territory.

Furthermore, the 30 percent tax has not produced resounding benefits for the Virgin Islands. Limited investment has resulted in a smaller tax pool and many businesses in the islands have not declared dividends in order to avoid the 30-percent tax by accumulating earned surplus. In 1981, our biggest collection year, the Virgin Islands Government received $888,883 in withholding taxes from this source. This figure is galling when compared with the cumulative effect of reduced job opportunities, higher capital costs, reduced investment and the resulting lower tax revenue base.

For this reason I introduced H.R. 5113 in December of last year; the amended version, H.R. 5985, is before you today. H.R. 5985 differs from H.R. 5113 in the second section of the bill only, and to this section it makes certain technical amendments.

The first section of H.R. 5985 calls for the reduction of the 30-percent withholding tax to 10 percent, giving the Virgin Islands Legislature the power to reduce the tax further as it sees fit. The reduction to 10 percent makes the Virgin Islands competitive with its Caribbean neighbors, while allowing the Virgin Islands Government some withholding tax revenues. If, in the future, a greater incentive is deemed more advantageous than revenues which would be foregone, the Virgin Islands could reduce the tax further on all, or on certain types of passive income.

Mr. Chairman, our request this morning is certainly reasonable. There is precedent for such a reduction in territorial tax withholding. In 1972 Guam reduced its 30-percent withholding tax on all passive income to zero. This change was fully supported by the Treasury Department.

The second section of the bill would allow for a foreign tax credit against U.S. taxes without the Internal Revenue Code section 904 limitations. This provision would give the Virgin Islands the benefit of receiving its 10 percent tax, while further reducing the tax disincentive for industry. This provision is an important revenue issue for the Virgin Islands, particularly in light of the pressures on the local government resulting from reduced revenues due to our mirror of the Tax Reform Act of 1981, cutbacks in Federal programs, and the demand for capital expenditures in Government services, which it is becoming increasingly impossible to meet.

The Treasury Department, before this committee this morning, however, has objected to the second section of H.R. 5985 for tax policy reasons. Thus, in the interest of getting the bill passed in this Congress, which I consider crucial, I am prepared to drop the second section. For the reasons stated above, this has been a difficult decision for me. Early passage of the first section of H.R. 5985, however, must be our overriding concern. It is from the initial 20 percent reduction that we expect the surge in our ability to compete for business investment.

This legislation is important for the people of the Virgin Islands. The local government is increasingly feeling the pressures created by unemployment. Passage of H.R. 5985 would provide a healthy investment incentive that would lead to more jobs, a better circulation of capital and more available mortgage money. It promises more revenues to the Virgin Islands treasury than ever resulted from withholding of the 30-percent tax. In these times when the territories in particular are feeling the brunt of financial hardships experienced across the country, these are important considerations.

Chairman STARK. Thank you, Ron, very much. Do the other members of the panel want to proceed to summarize their statements?

Governor, we have got you next on the list. Will you proceed?

STATEMENT OF HON. JUAN LUIS, GOVERNOR, VIRGIN ISLANDS

Governor LUIS. Thank you very much, Mr. Chairman.

Mr. Chairman, distinguished members of this subcommittee, thank you for this opportunity to state the views of the U.S. Virgin Islands regarding H.R. 5985, a bill which has the very strong potential to diversify and strengthen the Virgin Islands economy.

I would like to summarize my statement which has already been submitted for the record. The Virgin Islands economy is suffering from the recession in the United States. Unemployment is up, and economic development has stagnated. Our local tax incentive laws authorized under Federal statute are not producing results in terms of increased investment, despite our best efforts at promoting the Virgin Islands as an investment location.

These problems are caused by other factors in addition to the recess, however. From studies we have performed, and from discussions with potential private sector investors who have decided to postpone their investments or to make their investments elsewhere, we have identified what we believe to be one of the most significant disincentives for investing in the U.S. Virgin Islands, the so-called 30-percent withholding tax made applicable by the mirror system of taxation to dividends, interest, and other passive income payments from the Virgin Islands to the United States and foreign recipients.

This withholding rate compares quite unfavorably with that of our competitors for the U.S. investment dollar in the Caribbean and elsewhere. Most investors in Puerto Rico, our neighbor and primary competitor for industrial investment, are not subject to any federally imposed income taxes of this or any other type, and the locally imposed Puerto Rican tollgate tax on passive income can be reduced as little as 4 percent under the Puerto Rico tax incentive program.

Our sister territory in the Pacific was specifically exempted from the 30-percent tax by Congress in 1972. Many of our foreign competitors in the Caribbean are the subject of tax treaties with the United States, which result in withholding rates ranging from 5 to 15 percent. Considering these facts, it is no wonder that the Virgin Islands industrial incentive laws have not lived up to expectations.

To remedy this situation, last year I asked the Virgin Islands delegate to Congress, Hon. Ron de Lugo, to introduce legislation, which is now before you in the form of H.R. 5985.

The bill would reduce the withholding rate on passive income source in the Virgin Islands to 10 percent, and it would permit the local government to reduce the withholding rate even further if necessary. It also provides for a separate system of credits for these taxes against U.S. tax liability.

Mr. Chairman, the positive impact that this legislation would have on the economy of the U.S. Virgin Islands cannot be understated. Not only will H.R. 5985 directly encourage new capital and job-created investments in the territory, by permitting repatriation of profits at a reasonable rate, but it will also open a wide range of new sources of investment financing for both new and existing businesses.

Under existing law no responsible financial institution in the United States will lend money to Virgin Islands investors at rates similar to those offered to stateside investments, knowing that the interest payments received from the Virgin Islands will be subject to a withholding tax rate of 30-percent.

This situation not only discourages manufacturing and tourism-related investment, but it also has essentially closed the secondary market to Virgin Islands financial institutions, making home mortgages very difficult to obtain in the territory.

Although the Virgin Islands is treated as a foreign country under the Internal Revenue Code, the fact is that it is not a foreign country. Virgin Island citizens are U.S. citizens, and we are under the American flag.

Ironically, this is a major lure to investment in the territory, but by not being a foreign country we cannot enter into a tax treaty with the United States to lower the withholding tax rate, and under our revised organic act we may not enact our own basic income tax laws.

Rather, in this case Federal legislation is needed and only Congress can help us correct the inequity in the system. By amending the 30-percent tax provision to eliminate what is designed as a confiscatory rate of tax, Congress can help us improve our economy by allowing the Virgin Islands to create new investment opportunities in the territory for both United States and foreign investors, and it will help us create new jobs and new sources of revenue.

Mr. Chairman, H.R. 5985 is the vehicle for creating these investment opportunities. It is consistent with the U.S. policy toward its territories by permitting us the degree of additional autonomy that we need in order that we may help ourselves to stimulate the local economy.

It is consistent with the new and developing emphasis of the Federal administration to encourage new private sector investment in the Caribbean. It has a very broad base of support within the local community, and it has been endorsed by the local legislature.

Mr. Chairman, H.R. 5985 is deserving of the committee's support and the support of the entire Congress. On behalf of the government, business, and people of the U.S. Virgin Islands, I urge its prompt and favorable consideration.

Thank you very much.

Chairman STARK. Thank you, Governor.

[The prepared statement follows:]

STATEMENT OF
HONORABLE JUAN LUIS, GOVERNOR,
UNITED STATES VIRGIN ISLANDS

Mr. Chairman, distinguished members of this subcommittee, thank you for this opportunity to state the views of the United States Virgin Islands regarding H.R. 5985, a bill which has the very strong potential to diversify and strengthen the Virgin Islands economy.

Section 934 of the Internal Revenue Code was adopted by Congress in 1960. Together with Section 28(a) of the revised Organic Act of the Virgin Islands of 1954, it serves as the framework within which the U.S. Virgin Islands encourages investment from the United States and elsewhere. These provisions of the United States tax law were intended to permit the Virgin Islands to bring about economic diversification and to create private sector jobs through tax incentives. However, despite the best intentions of the federal lawmakers and despite the best efforts of our local government to promote these incentives, our economy remains over-dependent on tourism and on government employment which together account directly for about 60% of all the jobs in the Territory.

From studies we have performed, and from discussions with potential private sector investors who have decided to postpone their investments or to make their investments elsewhere, we have identified what we believe to be one of the most significant disincentives for investing in the U.S. Virgin Islands, the so-called "30% withholding tax". This tax, imposed by Sections 871, 881, 1441, and 1442 of the Internal Revenue Code, is applied to the Virgin Islands under the "mirror system" of taxation. Under that system, the Internal Revenue Code applies to the Virgin Islands, but wherever the words "United States" appear, the words "Virgin Islands" are substituted. As applied to the sections mentioned above, this means that the Virgin Islands Government is required to tax at the source in the Virgin Islands 30% of all payments of passive income, including dividends, interest, and rents, which are paid to persons in the United States and elsewhere.

This withholding rate compares quite unfavorably with that of our competitors for the U.S. investment dollar in the Caribbean and elsewhere. Most investors in Puerto Rico, our neighbor and primary competitor for industrial investment, are not subject to any federally imposed income taxes of this or any other type, and the locally imposed Puerto Rican "tollgate" tax on passive income can be reduced to as little as 4% under the Puerto Rico tax incentive program. Guam, our sister territory in the Pacific, was specifically exempted from the 30% tax by Congress in 1972. Many of our foreign competitors in the Caribbean are the subject of tax treaties with the United States which result in withholding rates ranging from 5 to 15 percent. Considering these facts it is no wonder that the Virgin Islands industrial incentive laws have not lived up to expectations.

To remedy this situation, last year I asked the Virgin Islands Delegate to Congress, the Honorable Ron de Lugo, to introduce legislation which would reduce the withholding rate on passive income sourced in the Virgin Islands to 10 percent and which would permit the local government to reduce the withholding rate even further if necessary. The result is Section 1 of H.R. 5985, which is now before this subcommittee.

Section 2 of the bill addresses a closely related problem. Under the mirror system, the 30% tax is considered a foreign tax and therefore, in theory at least, payment of the tax may be credited by U.S. taxpayers against their U.S. tax liability under Section 901. But we have found that most U.S. investors have not been able to make use of the credit due to limitations imposed by Section 904. Therefore, to solve this problem, Section 2 of the bill creates a credit limitation system for taxes paid to the Virgin Islands, separate from that applied to other foreign investments.

Mr. Chairman, the positive impact that this legislation will have on the economy of the U.S. Virgin Islands can not be understated. Not only will H.R. 5985 directly encourage new capital and job-creating investments in the Territory by permitting repatriation of profits at a reasonable rate, it will also open a wide range of new sources of investment financing for both new and existing businesses. Under existing law, no responsible financial institution in the United States will lend money to Virgin Islands investors at interest rates similar to those offered to stateside investments knowing that the interest payments received from the Virgin Islands will be subject to a withholding tax rate of 30%. This situation not only discourages manufacturing and tourism-related investment, it also has essentially closed the secondary mortgage market to Virgin Islands financial institutions. The effect of this has been to make home mortgages very difficult to obtain in the Territory, forcing thousands of Virgin Islanders to abandon their hopes of some day owning their own homes, and resulting in a very serious housing shortage in the Territory. The Virgin Islands Department of Commerce will soon be submitting additional testimony for the record to give the Committee further details on these and other economic problems which H.R. 5985 will help solve.

The 30% tax was designed as a confiscatory tax -- it was intended to encourage foreign countries to enter into tax treaties with the United States so that the rate of tax could be reduced to a reasonable level and thus permit investment in those countries. Although it is treated like one under the Internal Revenue Code, the U.S. Virgin Islands is _not_ a foreign country. Virgin Islands citizens are U.S. citizens and we operate under the American flag -- ironically, this is a major lure to investment in the Territory. But by not being a foreign country we can not enter into a tax treaty with the United States to lower the withholding tax rate and under our Revised Organic Act we may not enact our own basic income tax laws.

In the past we have met with some degree of success in working with the U.S. Internal Revenue Service to obtain technical assistance and rules and regulations to help us administer our tax laws, but in this case legislation is needed and only Congress can help us correct the inequity in the system. By amending the 30% tax provision to eliminate the confiscatory rates of the tax, Congress can help us improve our economy by allowing the Virgin Islands to create new investment opportunities in the Territory for both U.S. and foreign investors and it will help us create new jobs and new sources of revenue.

Mr. Chairman, H.R. 5985 is the vehicle for creating these investment opportunities: It is consistent with United States policy toward its territories by permitting us the degree of additional autonomy that we need in order that we may help ourselves stimulate the local economy; it is consistent with the new and developing emphasis of the federal administration to encourage new private sector investment in the Caribbean Basin; it has a very broad base of support within the local community and it has been endorsed by the local Legislature (see Attachment A). Mr. Chairman, H.R. 5985 is deserving of the Committee's support and the support of the entire Congress. On behalf of the government, businesses, and people of the U.S. Virgin Islands, I urge its prompt and favorable consideration.

Thank you very much.

Attachment A to Statement
of Honorable Juan Luis

Resolution No. 1054

BILL No. 14-0481

FOURTEENTH LEGISLATURE OF THE VIRGIN ISLANDS

OF THE UNITED STATES

Regular Session

1981

To request the Virgin Islands Delegate to Congress to introduce legislation to amend the Internal Revenue Code to reduce the 30% withholding tax to 10%, and for other purposes

---0---

WHEREAS the U.S. Internal Revenue Service has, effective June 22, 1981, amended its Income Tax Regulation 1-1441-4 (d) which specifically exempted Virgin Islands residents from being treated as withholding agents for a 30% withholding tax on any item of income in the form of interest, dividends, rents, royalties and so forth; and

WHEREAS the revocation of Income Tax Regulation 1-1441-4 (d) will now mandate that this 30% withholding tax on such income be first deducted by the resident in the U.S. Virgin Islands paying such income and then remitted to the Government of the Virgin Islands; and

WHEREAS compliance with this withholding tax of 30% will be a tremendous impediment to the development and diversification of the economy of the U.S. Virgin Islands; and

WHEREAS to their economic advantage businesses will refrain from locating in the U.S. Virgin Islands and established businesses will relocate elsewhere in order to avoid paying this tax; and

WHEREAS businesses which will suffer most heavily from this tax are the foreign companies operating U.S. Virgin Islands subsidaries that provide needed jobs for local people; and

WHEREAS there will be a greater difficulty in obtaining loans from off-island sources because investors and lenders will be concerned with the 30% tax on dividends and interest payments; and

WHEREAS these off-island loans are essential because local financial resources are usually inadequate for prospective loan demands such as those required for large projects needing mortgage financing; and

WHEREAS the 30% withholding tax will have a most damaging impact upon local manufacturing industries, and will discourage industrial development in the U.S. Virgin Islands; and

WHEREAS the business loss to the U.S. Virgin Islands far outweighs the potential gains, if any, derived from this tax; and

WHEREAS subsequent compliance with the 30% withholding tax can only be economically damaging to the people of the U.S. Virgin Islands; Now, Therefore,

BE IT RESOLVED by the Legislature of the Virgin Islands:

SECTION 1. The Virgin Islands Delegate to Congress is hereby requested to introduce legislation and take whatever steps are necessary to amend the Internal Revenue Code to reduce the 30% withholding tax to 10%, with the authority vested in the Legislature of the Virgin Islands to further reduce or eliminate the rate of that tax as it applies to the Virgin Islands.

SECTION 2. Copies of this Resolution shall be sent to the Commissioner of the U.S. Internal Revenue Service; to the Chairman of the Committee on Finance, U.S. Senate; to the Chairman of the Committee on Ways and Means, U.S. House of Representatives and to the Virgin Islands Delegate to the United States Congress.

Thus passed by the Legislature of the Virgin Islands on October 8, 1981.

Witness our Hands and the Seal of the Legislature of the Virgin Islands this 8th Day of October, A. D., 1981.

Ruby M. Rouss

RUBY M. ROUSS
President

RUBY SIMMONDS
Legislative Secretary

Chairman Stark. Our next witness is Mr. Kimmelfield, counsel for the Virgin Islands Trade and Development Institute.

You may proceed.

STATEMENT OF NEIL KIMMELFIELD, COUNSEL, VIRGIN ISLANDS TRADE & ECONOMIC DEVELOPMENT INSTITUTE

Mr. Kimmelfield. Thank you.

Mr. Chairman and members of this committee, the Virgin Islands Trade & Economic Development Institute is pleased to have this opportunity to state its unequivocal support for H.R. 5985, commonly referred to as the "30 percent bill."

The Institute is an independent, nonprofit organization dedicated to the promotion of economic development and business investment in the U.S. Virgin Islands. Its members include both U.S. companies operating in the Virgin Islands and local territorial businesses.

For reasons which are stated eloquently in the testimony of Governor Juan Luis and Congressman de Lugo, a reduction in the 30 percent Virgin Islands withholding tax would immeasurably benefit both the Virgin Islands and the Virgin Islands business community.

The Institute would like to take this opportunity to explain the technical operation of H.R. 5985 as a measure which will equitably accommodate the needs of both the Virgin Islands and the Virgin Islands business community without impairing the ability of the U.S. Treasury to curtail tax treaty or tax haven abuses.

The key provision of H.R. 5985 is section 1, which reduces the maximum Virgin Islands withholding tax rate from 30 percent to 10 percent, and, in addition, grants to the Virgin Islands government the power to further reduce the withholding tax below 10 percent.

Section 2 of the bill modifies the foreign tax credit provisions of the U.S. Internal Revenue Code with respect to Virgin Islands withholding taxes. The general intent of section 2 is to permit U.S. investors to obtain the benefits of the foreign tax credit for the 10 percent Virgin Islands withholding tax without regard to the foreign tax credit limitation, in order to lessen the pressure on the Virgin Islands government to reduce the withholding rate to zero.

Section 2 is complex mainly because it has been drafted to prevent a U.S. taxpayer from receiving an unlimited credit for the 10 percent Virgin Islands withholding tax while at the same time using tax subsidized income of a Virgin Islands subsidiary to increase the U.S. taxpayer's overall foreign tax credit limitation.

Although the U.S. Department of the Treasury is philosophically opposed to any alteration of existing foreign tax credit provisions, the Virgin Islands Trade Institute believes that section 2 is carefully and narrowly drafted so as to raise no significant issues of tax policy.

The basic provision of H.R. 5985, the reduction of the Virgin Islands withholding tax rate from 30 percent to 10 percent, has a zero revenue impact on the United States, since the withholding tax is payable only to the Virgin Islands Treasury.

Nonetheless, certain U.S. Treasury officials have expressed a concern that, because of the peculiar tax relationship of the Virgin

Islands to the United States, a reduced Virgin Islands withholding tax rate could create an opportunity for foreign investors to avoid the U.S. 30-percent withholding tax by funneling investments through shell corporations created in the Virgin Islands.

Although Treasury has not elevated this concern beyond the level of mere conjecture, the Virgin Islands Trade Institute would like to make it clear to the members of this committee that the institute has closely examined this bill in light of the concerns raised by the Treasury and has concluded, based upon a rigorous analysis of the Internal Revenue Code, that the bill creates no such opportunities for foreign investors.

Under current law, payment of U.S. passive income to a foreign investor—whether or not from a treaty country—through a Virgin Islands corporation necessarily results in either no payment of any withholding tax to either the United States or the Virgin Islands, or in payment of the full 30-percent withholding tax to the United States, depending on the kind of passive income developed.

In either case no Virgin Islands withholding tax is imposed, and the reduction of the Virgin Islands withholding rate from 30 percent to 10 percent can therefore have absolutely no impact on tax treatment of a funneling mechanism. The institute believes that there is no serious question regarding this conclusion.

Additionally, the institute would like to call this committee's attention to H.R. 4618, which was introduced in the Ways and Means Committee by Mr. Gibbons, and has received strong support from Treasury.

H.R. 4618 would repeal the 30 percent U.S. withholding tax on certain interest received by foreign investors for the purpose of encouraging and simplifying foreign investment in debt instruments of U.S. businesses. The institute believes that H.R. 5985 is in full accord with the spirit of H.R. 4618.

Finally, the institute states its emphatic disagreement with persons who oppose this bill on the ground that it creates, rather than reduces, a withholding tax. That view is based on a highly questionable interpretation of existing case law.

The institute would much prefer the certainty of congressional action to a fragile framework of judicially created tax law. Accordingly, the institute urges the speedy adoption of H.R. 5985 by this committee.

Thank you.

[The prepared statement follows:]

STATEMENT OF THE VIRGIN ISLANDS TRADE & ECONOMIC DEVELOPMENT INSTITUTE

Mr. Chairman and members of the House Ways and Means Subcommittee on Select Revenue Measures: The Virgin Islands Trade and Economic Development Institute (the "Institute") is pleased to have this opportunity to state its unequivocal support for H.R. 5985, commonly referred to as the "30 percent bill." The Institute is an independent, non-profit organization dedicated to the promotion of economic development and business investment in the United States Virgin Islands. Its members include both U.S. companies operating in the Virgin Islands and local territorial businesses.

For reasons which are stated eloquently in the testimony of Governor Juan Luis and Congressman de Lugo, a reduction in the 30 percent Virgin Islands withholding tax would immeasurably benefit both the Virgin Islands and the Virgin Islands business community. The Institute would like to take this opportunity to explain the technical operation of H.R. 5985 as a measure which will equitably accommodate the needs of both the Virgin Islands and the Virgin Islands business community, without impairing the ability of the U.S. Treasury to curtail tax treaty or tax haven abuses.

Under the Naval Appropriations Act of 1922 (48 U.S.C. § 1397) and the United States Internal Revenue Code, the Virgin Islands is required to impose a tax equal to 30 percent of the gross amount of dividends, interest, rents, royalties and other passive income paid to foreign persons, including U.S. persons. This tax, which must be withheld by the payor, is generally referred to as the "withholding tax."

The key provision of H.R. 5985 is Section 1, which reduces the maximum Virgin Islands withholding tax rate from 30 percent to 10 percent and, in addition, grants to the Virgin Islands Government the power to further reduce the withholding tax rate below 10 percent, without regard to restrictions generally imposed on Virgin Islands tax subsidies by the Internal Revenue Code.

Section 1 also provides that, despite the tax reduction, the current 30 percent withholding tax rate will continue to be applicable to dividends paid out of earnings accumulated prior to the effective date of the provision. This "grandfather clause" has been included because the withholding rate reduction is only intended to stimulate new investment and expansion of existing operations in the Virgin Islands. The 30 percent bill is not designed to permit existing businesses which have historically accumulated earnings to avoid the 30 percent tax by repatriating their earnings after the reduction takes effect. The Virgin Islands business community, recognizing the precarious fiscal position of the Virgin Islands Treasury, accepts this "grandfather clause" as a necessary means of preserving government revenues while at the same time stimulating new investment.

Section 2 of the 30 percent bill modifies the foreign tax credit provisions of the United States Internal Revenue Code with respect to Virgin Islands withholding taxes. The general intent of Section 2 is to permit United States investors to obtain the benefits of the foreign tax credit for the 10 percent Virgin Islands withholding tax without regard to the foreign tax credit limitation in order to lessen the pressure on the Virgin Islands Government to reduce the withholding rate to zero.

Section 2 is complex because it has been drafted to prevent a United States taxpayer from receiving a credit for the 10 percent Virgin Islands withholding tax while, at the same time, using tax-subsidized income of a Virgin Islands subsidiary to increase the U.S. taxpayer's overall foreign tax credit limitation, enabling it to obtain a credit for excess foreign taxes paid to other jurisdictions.

The mechanism for preventing this double benefit is a special "per-country" foreign tax credit limitation for taxes paid to the Virgin Islands by a Virgin Islands subsidiary. Prior to the Tax Reform Act of 1976, the "per-country limitation" was the general rule for determining a U.S. taxpayer's foreign tax credit limitation. The per-country limitation was repealed in 1976 partly to prevent a revenue loss which resulted from the IRS's inability to offset a taxpayer's foreign source losses from one country against the taxpayer's foreign source income from other countries in computing the foreign tax credit limitation. Such a revenue loss could not arise under a per-country limitation applicable only to income of a Virgin Islands subsidiary.

Although the U.S. Department of the Treasury is philosophically opposed to any alteration of existing foreign tax credit provisions, the Virgin Islands Trade Institute believes that Section 2 is carefully and narrowly drafted so as to raise no significant issues of tax policy.

The basic provision of H.R. 5985, the reduction of the Virgin Islands withholding tax rate from 30 percent to 10 percent, has a zero revenue impact on the United States, since the withholding tax is payable only to the Virgin Islands Treasury. Nonetheless, certain U.S. treasury officials have expressed a concern that, because of the unique relationship of the Virgin Islands to the United States, a reduced Virgin Islands withholding tax rate could create an opportunity for foreign investors to avoid the United States 30 percent withholding tax by funneling investments through shell corporations created in the Virgin Islands. Although Treasury has not elevated this concern beyond the level of mere conjecture, the Virgin Islands Trade Institute would like to make it clear to the members of this Committee that the Institute has closely examined the 30 percent bill in light of the concerns raised by Treasury, and has concluded, based upon a rigorous analysis of the Internal Revenue Code, that the 30 percent bill provides no such opportunities for foreign investors.

Under the Acts of Congress establishing the Virgin Islands tax system, and under the source of income rules provided in the Internal Revenue Code, payment of United States passive income to a foreign investor through a Virgin Islands corporation necessarily results in either no payment of any withholding tax to either the United States or the Virgin Islands, or in payment of the full 30 percent withholding tax to the United States, depending on the kind of passive income involved. In neither case is the Virgin Islands withholding tax imposed, and the reduction of the Virgin Islands withholding rate from 30 percent to 10 percent can therefore have absolutely no impact on foreign investment in the United States. The Institute believes that there is no serious question regarding this conclusion.

Finally, the Institute would like to call this Committee's attention to H.R. 4618, which was introduced in this Committee by Mr. Gibbons (for himself and Mr. Conable), and has received strong support from Treasury. H.R. 4618 would repeal the 30 percent United States withholding tax on certain interest received by foreign investors, for the purpose of encouraging and simplifying foreign investment in debt instruments of United States businesses. The Institute believes that H.R. 5985 is in full accord with the spirit of H.R. 4618, and urges the speedy adoption of the 30 percent bill by this Committee.

Chairman STARK. Thank you very much, Mr. Kimmelfield.

Mr. Duncan.

Mr. DUNCAN. I have no questions. I certainly welcome our colleague. Thank you for your excellent testimony. It will be of great help to us. I hope to give serious consideration to it.

Chairman STARK. My only regret with the legislation is that the excellent lobbying abilities of Congressman de Lugo are not available to me to help keep the Raiders in Oakland, which is a very important economic benefit to my home district. While he is busy trying to save the economy of the Virgin Islands, I don't have the use of his talents in that endeavor.

I hope that we can work out some kind of an accord with the Treasury. It just seemed to me from the testimony that they want to eliminate the 30-percent withholding. Then you are free to do what you want.

Is that correct? If they eliminate all withholding on investment, then the Virgin Islands can——

Mr. DE LUGO. We would be in the same position that Guam is in at the present time.

Mr. DUNCAN. And that would be all right.

Mr. DE LUGO. That would be preferable, and Treasury should have no problem with that. I stress, however, that our proposal is to reduce the tax to 10 percent, allowing the Virgin Islands Legislature the discretion to reduce it further.

Mr. DUNCAN. So basically if they prevail, this would be an interim measure?

Mr. KIMMELFIELD. I would like to point out that the measure with respect to Guam currently only affects U.S. investment in Guam, not foreign investment, and I believe the complete elimination of the 30-percent withholding tax, which was discussed by Mr. Chapoton, is H.R. 4618, which would repeal the 30-percent tax only on portfolio interest, while the measure we have before us now would apply to dividends and royalties as well, which are very significant for many investors, both United States and foreign.

Mr. DUNCAN. They have separate legislation, though, on withholding. You get into the question of withholding on dividends and interest, and I presume that would apply to everybody. So, what we have got are a couple of balls in the air at once.

Chairman STARK. The Treasury is meeting today on their position on withholding on interest and dividends. That may change before the week is out. I would urge you to continue your negotiations with the Treasury, not to say that your bill won't receive favorable consideration in this committee, but it does seem to me that if it is not in the Senate bill and if we are to consider it in this year's tax bill, the closer we can get to some kind of unanimity, why, the easier it will be to make sure it doesn't disappear somewhere in the negotiations.

Mr. DE LUGO. I think, Mr. Chairman, with your banking experience you can certainly see how important this is to us in the Virgin Islands. I think that is the course that we are pursuing. I think that Treasury and the Virgin Islands are close to agreement.

I am hopeful, as I said before, that they will see fit to support inclusion of the foreign tax treaty countries in this legislation. With that I am dropping the second section of my bill, and I hope that we can move it with no objections from Treasury

Mr. DUNCAN. I do, too, and it was my understanding that that would be their position.

Mr. DE LUGO. That is my understanding, also.

Mr. DUNCAN. That understanding didn't come from Treasury, so I would hope that would be the case.

I appreciate your efforts on behalf of the U.S. Virgin Islands. Thank you very much.

Mr. DE LUGO. I want to thank you, Mr. Chairman, and you, Mr. Duncan, for your kind remarks and for the statement of support from Congressman Schulze, a distinguished member of the Ways and Means Committee. Thank you.

Chairman STARK. The next witness is Mr. Sheldon S. Cohen, counsel for the International Telephone & Telegraph Corp.

STATEMENT OF SHELDON S. COHEN, ON BEHALF OF INTERNATIONAL TELEPHONE & TELEGRAPH CORP., ACCOMPANIED BY DENNIS B. DRAPKIN, COHEN & URETZ

Mr. COHEN. Good morning, Mr. Chairman.

Chairman STARK. Good morning, Sheldon. We have your testimony. You may proceed in any way you can to shed some light on this Virgin Islands problem. We appreciate your testimony.

Mr. COHEN. Yes, sir.

Mr. Chairman, Mr. Duncan, I am Sheldon Cohen, a partner in the law firm of Cohen & Uretz, Washington, D.C. I am accompanied by my law partner, Dennis Drapkin.

Chairman STARK. Will you pull that mike really close?

Mr. COHEN. How is that, sir?

I am here before you today representing the International Telephone & Telegraph Corp., which has operating subsidiaries in the Virgin Islands. They have a long relationship with the Virgin Islands.

The founders of ITT were born in the islands and started their very first telecommunications operation there 60 years ago. I am going to talk only about section 1, and I will try to skip the portions that have been covered by Assistant Secretary Chapoton and the gentlemen from the Virgin Islands, since they have summarized the nature of the legislation.

We are here supporting what Delegate de Lugo and the Governor want; that is, we want an economically healthy and viable Virgin Islands. The company operates there. It is a good citizen there. It wants a healthy economic climate in the islands.

We agree that the 30-percent withholding that they believe exists is a detriment because they keep raising it and because the Treasury has somehow or other cooperated with them in several respects.

The point is, Mr. Chairman, that we believe that the Treasury and the islands have misinterpreted the *Vitco* case. The highest court for the Virgin Islands happens to be the third circuit in the United States. Appeals from the district court down in the Virgin Islands go to the third circuit. Unless they go to certiorari in the Supreme Court, that is it. The third court has decided the case in the *Vitco* situation that there is no withholding tax, so that is it, and pretending to some extent that there is a withholding tax in regard to U.S. citizens, U.S. business, is all facade. It just does not exist.

That case went third circuit. Certiorari was sought by the government of the Virgin Islands. It was declined, so that is judicially the end of the road. In fact, if one reads the *Vitco* case very carefully, the case strongly supports the proposition that there is no withholding tax at all in regard to the United States.

Now, that basically is what the Governor asked for, what Mr. de Lugo asked for, and what the Congress gave to the Guamanian situation a number of years ago.

I think that basically is our position. The difficulty that we find ourselves in is that the Treasury and the Internal Revenue Service have for years taken a position that a taxpayer must turn square corners with his Government, and indeed there is much legislation, and there is much judicial authority to support that.

However, there is judicial authority that says just the converse of that also, that the Government must turn square corners with the taxpayer. In the situation we have at present, the Internal Revenue Service, in cooperation with the Treasury, in fact at the insistence of the Treasury, changed the set of regulations just a year or so ago, in which they withdrew the regulation on which the *Vitco* case is based, and substituted a revenue procedure which has, if you would like us to lay out, the virtually exact language of the regulation.

Therefore, after going through that charade—that is, withdrawing the offensive language in the regulation and superimposing this new revenue procedure, which is not a regulation—they now pretend again that there is a withholding tax.

I contend that if a taxpayer were to do that, the Government would probably send a special agent out for a fraud investigation. I find that to be appalling, and I have so told the Treasury on a number of occasions.

What we are talking about then is what is economically best for the Virgin Islands. The Treasury says hold off. We say yes, hold off, because there is no problem.

Insofar as U.S. entities are concerned, we believe there is no withholding, and we believe that there is no applicable tax. Now, that position is consistent with what the gentlemen from the Virgin Islands were asking for. They were asking for a tax fully applicable to foreign entities, and since the Revised Organic Act does not apply to foreign entities, it would have no interference.

We believe in basic summary that no legislation is needed. A simple reaffirmation of the *Vitco* case and its full implications would give the Virgin Islands the economic stimulus which they find necessary and which we support.

I find myself revisiting the Virgin Islands. In 1954, when the 1954 code was enacted, on the last day that the bill was before the Ways and Means Committee—excuse me, on the floor of the Congress—they discovered that someone had forgotten that the Organic Act for Guam and the Virgin Islands was enacted, and I was the one who had to revise to bring them into the 1954 code, so here I am again.

Thank you, sir.

[The prepared statement follows:]

Statement of
Sheldon S. Cohen

Mr. Chairman and Members of the Subcommittee:

My name is Sheldon S. Cohen. I am a partner in the law firm of Cohen and Uretz in Washington, D.C. I am appearing before you today on behalf of the International Telephone and Telegraph Corporation, which has operating subsidiaries in the Virgin Islands. ITT's relationship with the Virgin Islands is a long and close one. It antedates all the tax problems that concern us here. The Behn brothers, who founded ITT, were both born in the Virgin Islands and started their very first telecommunications operations in the Caribbean well over 60 years ago.

My remarks are limited to section 1 of H.R. 5985. Section 1 would impose a tax liability of up to 10 percent upon passive income received from Virgin Islands sources by United States taxpayers. A corresponding withholding tax liability would be imposed on the payor of such income. It is our understanding that section 1 is intended to provide the government of the Virgin Islands with the authority to vary the tax rate from zero to 10 percent.

I am here to support the principles that Delegate de Lugo so cogently stated in the Congressional Record of December 3, 1981 when he introduced H.R. 5113, the predecessor of the bill that is now before the Subcommittee. In his remarks on that date, Mr. de Lugo graphically described how a 30-percent V.I. withholding tax impeded the economy of the Virgin Islands, made it "increasingly difficult" for the Virgin Islands "to compete for offshore jobs," and has "stifled business expansion." This has led to an economic situation in the Virgin Islands, according to Mr. de Lugo, in which "no one wins" other than Virgin Islands' competitors and in which "the losers include Virgin Islands workers and entrepreneurs and strangely enough the Virgin Islands Treasury itself." Mr. de Lugo refers to the "tunnel vision" of current Virgin Islands tax policy, which views revenue estimates without taking into account "reduced job opportunities, higher capital costs, reduced investment and subsequently a lower tax revenue base." Mr. de Lugo wants healthy investment incentives and an improved economy for the Virgin Islands.

We fully support Mr. de Lugo's objectives; we want them too for the Virgin Islands. ITT companies are in business there. We want the U.S. Congress to provide significant help to the economic development of the Virgin Islands. Congress should meet these objectives, however, by voting down, not by passing, Mr. de Lugo's well-intended bill. It is not needed. It is based on a false premise. If you vote down the bill, you will be telling the revenue authorities of both the U.S. and the V.I. to stop playing games with Virgin Islands tax withholding, and you will remove the Congress from possible interference with tax litigation in the Virgin Islands.

The plain fact of the matter now before you is that U.S. courts have held that there is no Virgin Islands withholding tax on payments of dividends and interest from the Virgin Islands to the United States. The economic problems set forth by Mr. de Lugo in his statement of December 3rd have arisen because of efforts by both U.S. and V.I. tax authorities to claim that the withholding tax does exist despite case law that there is no such tax. Obviously, this strange action by the tax authorities has created a tremendous disincentive against new business investment in the Virgin Islands, with the results that Mr. de Lugo has so clearly described.

Five years ago, the United States Court of Appeals for the Third Circuit held unanimously in Vitco, Inc. v. Government of the Virgin Islands that there was no Virgin Islands withholding tax on dividends and interest paid from the Virgin Islands to U.S. residents who pay tax to the United States. The Supreme Court of the United States denied review. Not only did Vitco hold that there was no V.I. withholding tax, but the reasoning of the case clearly demonstrates that both the Revised Organic Act of the V.I. and the principles of United States-Virgin Islands tax equality (as defined in the landmark Chicago Bridge and Iron

Co. case of 1970) mandate that no V.I. tax could be imposed upon U.S. recipients of dividend or interest income from the V.I.

Despite the clear language of the Vitco opinion (which is binding upon the V.I. government as the opinion of the highest court with jurisdiction over V.I. matters), both V.I. and U.S. tax officials have tried not to follow that case. In fact, last year, the U.S. Treasury Department sought to reverse the withholding tax decision by a sham administrative amendment (and I use that term deliberately, Mr. Chairman) changing a U.S. withholding tax regulation excepting V.I. residents from U.S. withholding to a published revenue procedure providing the very same exception. Incredible as it may seem, some U.S. and V.I. tax officials apparently thought that converting a regulation to a revenue procedure allowed them to override the decision of the Third Circuit in Vitco. This is a tax sham, Mr. Chairman. The courts do not allow taxpayers to perpetrate tax shams; and they will not allow the government to perpetrate tax shams.

What has been the effect of the attempts by V.I. and U.S. revenue officials to keep withholding alive despite the 1977 Vitco decision? I need not tell you what they are. Mr. de Lugo has already done so. His words deserve repetition -- a massive disincentive to American investment; a stifling of business operations; an inability to compete; a loss to V.I. workers and entrepreneurs; and a loss to the V.I. Treasury itself. It is hard to envision a more objectionable policy by tax officials -- a policy designed to cut off one's nose to spite one's face. This has been the drastic result of five years of refusal by V.I. and U.S. tax authorities to accept the decisions of U.S. courts that there is no V.I. withholding tax.

What about the bill now before you? I respectfully submit that everything that the V.I. government seeks to accomplish through section 1 of H.R. 5985 can readily be accomplished without the need for legislation. All that the V.I. government must do is to recognize the binding effect of a decision of its highest court. This is a fundamental constitutional requirement on which this country is founded; we are a government of law, not men. Tax officials are required under our system of government to recognize decisions of courts that have appropriate jurisdiction.

Because the V.I. government has not accepted the Vitco decision, my clients are involved in new Virgin Islands tax controversies which we are confident will fully reaffirm that decision. Furthermore, due to the complex legal background that lies behind the proposed legislation, I strongly feel that enactment of the proposed legislation would only add to existing confusion and economic disincentives.

It is easy to support a bill that purports to reduce taxes. But when that bill in fact increases taxes and interferes with past litigation that is binding on the government and with present litigation that would readily accomplish the objectives of the bill, no purpose is served by proceeding with the legislation. The Third Circuit resolved the question before you in 1977; I respectfully urge you to help the economy of the Virgin Islands by allowing that decision to stand so that the economy of the Islands can be permitted to grow unhampered by attempts to enforce an invalid withholding tax.

The objectives of Delegate de Lugo are admirable; let us attain them by following the binding U.S. court decisions. I respectfully urge the Subcommittee to report H.R. 5985 unfavorably.

Thank you once again for the opportunity to appear before the Subcommittee.

Chairman STARK. Thank you.

Mr. Duncan.

Mr. DUNCAN. I have no questions. I would like to thank the Commissioner.

Chairman STARK. I can only add that I appreciate your being here. You think there has got to be a simple way out of this. I don't know with the Caribbean Initiative over us, we have got the idea of repealing the 30-percent withholding on foreign portfolio investment. We also have potential withholding on all interest and dividends, which makes it seem rather difficult. There is some difference in the administration's position.

Mr. COHEN. The simplest way, of course, is to stand still. The act, as I understand it, the bill that is before you, would allow the government of the Virgin Islands the authority to wait to move that tax from 10 percent down to zero, if it will, and we understand there is some pressure in the Virgin Islands to make it zero, to really compete with Guam.

In fact, there are many places in the Caribbean, Puerto Rico, where the tax rate is effectively zero for U.S. corporations during substantial periods of time, so if they are going to compete, they are going to have to go to zero.

The interest situation only covers interest; that is, the zero withholding rate that is being discussed is only in regard to interest, and wouldn't affect dividends. Therefore, it would help them perhaps with some bankers making investments in real estate or other types.

But substantial capital investments are not made that way. Substantial capital investments are made like our client ITT does. It goes down, it builds a telecommunications facility. It has its own equity in it, and it wants to repatriate—not even repatriate, we are all in the United States—it wants to move some of that cash as it earns it back to the parent company, and then it moves cash back out from the parent company to build new facilities.

It wants to be able to do that freely. If they are going to impose any tax, if you give them the authority—we believe that there will be no tax unless you give them the authority—if they are going to impose any tax, they are going to inhibit ITT and other substantial businesses from going down there because there are many other places where you don't have that gross withholding tax.

That is the problem, sir. It is a gross withholding tax for which you may never get any benefit.

Chairman STARK. Thank you very much.

Mr. COHEN. Thank you.

Chairman STARK. The next witness is Maj. Kenneth F. Hanst, Jr., president of the Army Mutual Aid Association, accompanied by George D. Webster, counsel for the Army Mutual Aid Association.

Mr. DUNCAN. I would like to welcome Mr. Webster and Mr. Hanst to the committee. The chairman had to step out for a moment, so you may just proceed as you wish with your statement. If you would like to summarize your statement, it will be placed in the record in its entirety.

STATEMENT OF MAJ. KENNETH F. HANST, JR., PRESIDENT, ARMY MUTUAL AID ASSOCIATION, ACCOMPANIED BY GEORGE D. WEBSTER, COUNSEL

Major HANST. Thank you, sir.

The Army Mutual Aid Association was established in 1979 to provide benefits to Army personnel and their dependents. This is still our big mission. The association has never been subject to income tax since its inception, and is presently exempt under section 501(c)(9) of the Internal Revenue Code.

The Internal Revenue Service attempted to revoke its exemption in 1980 but reversed itself after a prolonged and costly dispute. The IRS issued new regulations in January 1981. We have not yet been audited by the IRS, since the issuance of the new regulations, and we are therefore uncertain as to how the IRS will apply the regulations to the Army Mutual Aid.

One thing which the audit did teach us is that we are a round peg in a square hole under section 501(c)(9). That section was devised to cover small groups of employees gathering together in informal associations. Presently it covers everything from life and accident plans of major corporations to health and accident plans of unions and trade associations.

Army Mutual Aid is an entirely different animal. It is truly a mutual benefit society whose function and uniqueness derive from those it serves: the personnel of the U.S. Army.

The functions which AMAA performs, from assisting widows of veterans in claiming benefits due them under Federal law to providing small amounts of insurance, assist not only the veterans involved, but the Government itself, by improving the lot of servicemen as well as their satisfaction with their profession.

The Army Mutual Aid was founded by concerned Army officers and has been closely connected with the Army since its inception. This is an entirely different situation from the corporate labor union and trade association programs which are normally exempt from tax under section 501(c)(9).

We believe that the best solution to eliminate the uncertainty caused by this state of affairs is the creation of a specific tax exempt status specially tailored for the Army Mutual Aid Association and the Navy Mutual Aid Association. H.R. 6218 would do this.

I would point out that in the description of the bill handed out today it was indicated that budget receipts would be reduced by less than $5 million. While this statement is not incorrect, it might more properly say that there would be no loss of budget receipts.

The representative of the Treasury handed out a figure as a profit. Our income goes entirely into paying expenses and into our reserves that we may provide future death benefits.

There was also talk that we were seeking to broaden our membership. An individual to join our association must be on active duty. Ninety percent of our members are indeed war veterans, but with the passage of time it is possible that we could get down to that 75-percent figure.

I would say that no one wants us to have a war every 10 years so that we can keep our membership up to higher than 75 percent of war veterans. But we have no intention of insuring dependents; that is not our mission.

That concludes my statement with the one last expression to you, sir, for introducing this bill, and we urge the subcommittee to recommend its passage to the Committee on Ways and Means and to the House of Representatives.

[The prepared statement follows:]

STATEMENT OF MAJ. KENNETH F. HANST, JR., CLU, PRESIDENT OF THE ARMY MUTUAL AID ASSOCIATION

The Army Mutual Aid Association strongly supports H.R. 6218, which would create a special class of tax exemption recognizing the status of AMAA as a long-standing contributor to the well-being of this country's military personnel. This Bill would involve no revenue loss, because the only organizations meeting the requirements of the proposed section are presently recognized as tax-exempt under Section 501(c)(9) of the Code. It would insure that the Army Mutual Aid Association may continue its beneficial activities without interruption.

When the Seventh Cavalry was destroyed in the Battle of the Little Big Horn in 1876, the bereaved families were left without resources to return to their homes. Life insurance was rarely available to help. Most companies refused to insure the military, and those few which did charged substantial extra premiums. Thus, any meaningful amount of life insurance was beyond the reach of the officer subsisting on meager army pay. The plight of the survivors received widespread attention and led to the founding of the Army Mutual Aid Association by concerned Army officers in 1879.

AMAA was intended to provide a modest amount of immediate financial assistance and a substantial amount of lifetime administrative support to the survivors of its members.

It has always enjoyed exemption from federal income tax under Section 501(c)(9) of the Internal Revenue Code of 1928 and its predecessors. As you know, 501(c)(9) applies to employee beneficiary associations providing life, sick, accident and similar benefits to employees.

In 1980, the Internal Revenue Service proposed revocation of the tax-exempt status of the Association based upon regulations which has been proposed in 1969, but never issued in final form. The National Office of the Internal Revenue Service initially proposed to affirm the revocation. After a prolonged worrisome and costly dispute, it reversed itself and continued the exemption of the Association.

We believe that the proposed legislation is necessary to obviate future attacks upon the tax-exempt status of AMAA. In short, we are seeking legislative protection against harassment by an executive agency.

The dispute with IRS in 1980 was expensive. It cost us in excess of $30,000 in legal fees and associated costs. But of greater importance, the attack by the IRS placed the Association in planning limbo for two years. It raised the possibility of licensing in and reporting to 50 states; it would have compromised our nonpaid Board of Directors which includes the Chief of Staff of the Army; it would have denied our services in the area of consumer education; and it would have interrupted, if not negated, our problem of providing the ever-increasing death benefits we pay to the survivors of our members.

I would stress that our services include total assistance in every aspect of claiming all benefits due from the government and private sources. And unlike the civilian life industry, our contact with the survivors is continued for life in order that we may inform them of and assist them to claim benefits accruing because of new or changed laws.

The final regulations under Section 501(c)(9) issued in January 1981 contain a number of vague new concepts which may or may not be applicable to AMAA, depending on IRS interpretation. Section 501(c)(9) was devised for a different type of organization than the Association.

The Army Mutual Aid Association and its sister organization, the Navy Mutual Aid Association, are the only ones of their kind. I fear that future IRS audits applying the new regulations may raise problems similar to those raised by an agent in 1980, and again disrupt our activities. It is desirable for the organization, the veterans and dependents which it protects and the tax system as a whole that the matter be settled permanently by the enactment of H.R. 6218.

Mr. DUNCAN. You mentioned assistance to survivors. What kind of assistance does the association provide, Mr. Hanst?

Major HANST. The initial assistance is in immediate payment of the monetary benefit. As soon as we receive word from the Army that an individual has died, we call the beneficiary and we will wire the money immediately if it is needed, or the check will be in the mail that day or the following day.

More importantly, we help her claim all her other life insurance and all her government benefits. Most importantly, we are available to her forever. If I might cite one scalpel when Congress extended the survivor benefit plan to cover the widows of those who had died on active duty with more than 20 years of service.

Prior to the passage of the survivor benefit plan, there was no way for any Government agencies to find these eligible widows. We went back through our files, and of the number of request claims received at the Army Finance Center, more than half of them had been initiated by our office.

So the permanence of the help is quite important.

Mr. DUNCAN. Do you consider your reserves excessive?

Major HANST. I might point out that our procedure over the years has been to increase the benefit of the insurance as we can afford to do so.

We employ Johnson & Higgins as our actuarial consultants, and when they tell us that we can increase the amount of the insurance that each member holds——

Mr. DUNCAN. The reserves question was brought out by the Treasury, which stated that you transferred $7 million to reserves. You don't consider that an excess amount?

Major HANST. No, sir; all that means is we will sooner be able to increase the benefit again.

Mr. DUNCAN. Now, you are nonprofit; if you make money, what do you do with your profit?

Major **Hanst**. The funds are invested until such time that we have sufficient excess reserve to increase, as, for example, the last time the benefit was increased from $5,000 to $6,500.

Mr. **Duncan**. You provide death benefits. Do you provide anything else while the members are living?

Major **Hanst**. The member consults with us in order to get unbiased advice on life insurance in order to be educated on survivor benefits that are available to his family if he should die, and we hope that through that educational program he will, in turn, be able to assist his enlisted personnel in knowing and understanding these benefits.

Most importantly, we provide each member each year with a computer printout that is based on his particular family situation, to show that we have all the necessary documents to help his family and show the exact number of dollars that would come to his family in the event of his death.

Mr. **Duncan**. How many members do you have?

Major **Hanst**. We have 48,000-plus, sir.

Mr. **Duncan**. Thank you very much, sir, for your excellent presentation.

Thank you, Mr. Webster.

Mr. **Webster**. Thank you, sir.

Mr. **Duncan**. Thank you for appearing, also.

I would like to call up H.R. 2402.

We have a representative of the American Fishing Tackle Manufacturers Association, Mr. Thomas R. Schedler, executive vice president; Mr. Dave Kern, comptroller, Zebco, accompanied by Dr. Ralph Biedermann, director of corporate relations of the Brunswick Corp.

I would like to say that Mr. Jones, one of the sponsors of the bill, was unable to be present, but will be submitting testimony for the record.

Your full statements will be in the record. You may summarize. You have 5 minutes to do that.

You may proceed as you wish.

I will start with you, Mr. Schedler.

STATEMENT OF THOMAS R. SCHEDLER, EXECUTIVE VICE PRESIDENT, AMERICAN FISHING TACKLE MANUFACTURERS ASSOCIATION

Mr. **Schedler**. Thank you, Congressman Duncan.

First of all, on behalf of the members of the American Fishing Tackle Manufacturers Association, I would like to take this opportunity to thank the committee for the opportunity to present our views and testify this afternoon in support of H.R. 2402, which I believe, as you know, has nine cosponsors, eight of whom are members of the House Ways and Means Committee.

I am Thomas R. Schedler, executive vice president of the American Fishing Tackle Manufacturers Association, and I would like to just comment briefly on the pertinent points that are contained in my written testimony, which I have submitted previously, and then to let you hear directly from one of our members as to the impact that the current regulations have on his day-to-day operations, and what fishing tackle manufacturers must do to try to cope with this unfair situation; and then to let you hear from labor and the impact that the current regulations of the Dingell-Johnson tax have on their members.

I would like to start out by saying that it is our strong contention that one of the unique characteristics of the 10 percent Dingell-Johnson excise tax, unlike other excise taxes, is that it was a self-imposed tax, without qualification, voluntarily, by the fishing tackle industry some three decades ago, back in 1952.

The funds from this tax are placed in a separate segregated fund and are allocated on a 3-to-1 matching basis from the Federal Government back to the States to assist them with their fishery management programs.

I should also like to make it clear this afternoon that AFTMA is not opposed to the existing Dingell-Johnson tax, as such, but rather to the current payment schedule that has been unilaterally established by the Department of the Treasury.

This is just one of several inequities that we have difficulty with, but a major one that has crept into the program over the years.

As I said, the funds that are realized from the Dingell-Johnson tax do provide States with a much needed source of revenue for managing their recreational fisheries, but the States still claim they do need additional moneys, and certainly we recognize that need.

But, because of the nature of the fishing tackle industry, we feel it is a unique necessity for manufacturers to be able to offer extended credit terms to their customers to prevent loss of sales. One of my colleagues will be commenting on this in detail in a few minutes. But this need really translates, or impacts, on employment and production.

In order for the manufacturers to pay the Dingell-Johnson excise tax on a timely basis, which is shortly after shipment, most fishing tackle companies are forced to obtain expensive short-term financing before they, themselves, even receive payment for their goods.

Of course, in today's economy we are talking 20 percent money or even better.

The effect of this on the consumer is that it creates an inflationary situation. These fishing tackle companies must build these costs into the cost of their product. So the net result is that the consumer pays more for his goods than he might otherwise—if the Government was not requiring early payment of the Dingell-Johnson tax.

The provisions of H.R. 2402 are quite simple. It seeks to defer payment of the tax for at least 90 days, but no more than 180 days, but will still require payments to be made in the same fiscal year. The D–J tax payments would be deferred in the first three quarters of the fiscal year to the next quarter, but the last quarter payments will take place in that same quarter.

Therefore, the revenue impact of H.R. 2402 on the U.S. Treasury, if any, would be extremely minimal. This bill, in essence, only changes the manner of bookkeeping, and the only potential loss to the Government could possibly be some slight interest income.

The current payment of regulations as imposed by the Department of the Treasury distort the economic forces governing the production and sale of the taxed fishing tackle items.

It should be noted that Treasury did unilaterally step up the time required for payment of the tax so that now a manufacturer must pay that tax normally on a twice a month basis.

H.R. 2402, we believe, is in conformity with the Regulatory Flexibility Act. It does not endanger the Federal aid in fish restoration program, which is more commonly known as the D–J program. In fact, we are confident the program would be enhanced by passage of this legislation.

Since the fishing tackle industry is 97 percent comprised of small businesses, it is small business that is being hurt by the current excise tax payment requirements. We believe this bill is consistent with the original intent of the D–J Act when it was established in 1952 and as such, should not be viewed as being precedent-setting for other excise tax interests.

Contrary to what Treasury indicated earlier this morning, or at least implied, the administrative fees are taken from the Dingell-Johnson fund itself and not from any other funds.

Further, the Government does receive interest from the moneys that are collected as they do revert back to the General Treasury. And I would submit that there is reason to question the propriety of this, as well.

So except for Treasury's opposition, this bill is and always has been a noncontroversial issue. During previous sessions of Congress, legislation passed out of this committee and the full House Ways and Means Committee with no dissenting votes and passed the full House on suspension.

The bill was also approved unanimously by the Senate Finance Committee and only Treasury's opposition prevented it from reaching the Senate floor in the 96th Congress.

So we ask that H.R. 2402 be given speedy and favorable consideration so that finally during this session of Congress, this much-needed relief, as called for in the bill, will be provided to fishing tackle manufacturers, small businessmen, who otherwise will continue to suffer unjustly from financial hardships they are forced to endure with this self-imposed excise tax program.

I would like to thank you for your concerns and I would be pleased to respond to any questions you have.

Thank you.

[The prepared statement follows:]

STATEMENT OF THOMAS R. SCHEDLER, EXECUTIVE VICE PRESIDENT, AMERICAN FISHING TACKLE MANUFACTURERS ASSOCIATION

Mr. Chairman, the American Fishing Tackle Manufacturers Association (AFTMA) is a national trade association headquartered in Arlington Heights, Illinois representing 400 manufacturers of fishing tackle and related equipment, which equates to over 95 percent of the industry. Of AFTMA's total membership, 97 percent of our firms may be defined as small businesses.

The basic objective of AFTMA is to educate, guide and assist the members of the Association in matters of common interest so that the members shall maintain a high standard of conduct, efficiency, and usefulness to the industry, to the government, and to the public.

The Association is the instrument by which business competitors cooperate to solve common problems, to launch and carry out industry-wide endeavors, to put individual knowledge and experience to work for all.

For 30 years, the fishing tackle industry has totally supported the concept of paying an excise tax on their equipment which, in turn, is earmarked for the Federal Aid in Fish Restoration Program, commonly known as the Dingell-Johnson or D-J Fund. This fund is one of the most substantial trusts available for conservation and fish restoration. The industry advocated the self-imposed excise tax legislation in 1952, further re-endorsed its support in 1964 and our position has not changed.

Before going any further, it should be explained that the Dingell-Johnson Program was the culmination of many years of effort by conservationists and enlightened sportsmen and fishing tackle manufacturers who saw a need to bolster the efforts of state fish and wildlife agencies in managing recreational fisheries. Congressman John Dingell of Michigan and Senator Edwin Johnson of Colorado introduced the legislation which provided that the ten percent manufacturer's excise tax on fishing rods, reels, creels, and artificial lures, baits, and flies be made available to states and territories for management projects and sport fishing recreation. In conjunction, the states must assure that their fishing license revenues are dedicated for only the administration of state fish and wildlife agencies.

The excise tax, collected by the manufacturer or importer and paid to the Treasury Department, is appropriated to the U.S. Fish and Wildlife Service annually for apportionment among the states and territories. Each state's share is based 60 percent on the number of licensed sport fishermen and 40 percent on the land and water area of the state. No state may receive more than five percent nor less than one percent of the total.

The cost of each D–J project is supported with 25 percent state funds and 75 percent D–J funds with most of the state money derived from sport fishing license revenues. Thus, because of the Dingell-Johnson program, most of America's 64 million sport fishermen benefit from the wide-range of projects aimed at helping our nation's fisheries.

The major problems confronting the fishing tackle industry are primarily as a result of the time schedule that is now required by Section 4161(a) of the Internal Revenue Code of 1954 for the payment of the ten percent tax on the value of applicable fishing tackle items. AFTMA and its member manufacturers do not challenge the percentage level of taxation, nor the amount of money that is ultimately collected from manufacturers throughout the year.

Under the current law, if the liability for excise tax reported exceeds $2,000 for any month in the preceding calendar quarter, the manufacturer must deposit his excise tax on a semi-monthly basis within nine days after the close of the period involved. Consequently, the manufacturer is required to deposit his excise tax at a time closely coinciding with the date of shipment. This is when the problem begins for small fishing tackle businesses. Currently, fishing tackle manufacturers do not receive payment for their products on the average of 4.4 months after the time of shipment.

The lag time between the shipping date and the time when payment is received from the vendee is a direct result of the fact that the fishing tackle industry has had to adhere to a highly seasonable, but predictable production cycle that basically begins with product development during the late spring and summer months; order taking during the latter part of the summer; and heavy shipments starting in October and continuing through March. In order to induce distributors and retailers to purchase the manufacturer's goods during periods of the year when they are not being heavily sold directly to the sport fisherman, it has been necessary for every member of the industry to grant "dating" terms to vendees to maintain steady employment and production.

The granting of these terms is dictated by the industry's customers and not the industry. This situation did not exist 30 years ago when the D–J fund was created. New problems have developed since 1952 which mandate that the industry seek relief from the contemporary problems of this increasingly serious dilemma of paying an excise tax well in advance of getting paid for the products taxed.

The overall consequence of this entire situation has been the ever-increasing need for small to medium sized businesses particularly, to obtain expensive, short-term financing in a highly competitive money market for a tax that should not have to be paid until the manufacturer receives his payment within a reasonable time period.

Other industries still covered by excise taxes such as gasoline, truck parts, inner tubes and tires, lubricating oil, etc., cannot demonstrate the seasonal shipping variations to the extent that exist for fishing tackle manufacturers and this is why we believe our cause is unique and non-precedent setting. Worse yet, as opposed to other industries subject to excise taxes, 97 percent of the tackle manufacturers are small businesses wherein cash flow is proportionately a much more intense problem, affecting every aspect of their operations.

Under the present law, a concentration of shipments also means a concentration of excise tax payments at a time when cash flow is crucial because of the extended payment terms which are necessary and prevelant in the industry. Consequently, most of the small fishing tackle businesses are forced to use short-term financing in a highly competitive market to pay the excise tax. The current excise tax payment schedule is causing substantial cash flow hardships affecting absolutely every other phase of the fishing tackle manufacturer's operation, from the purchase of components to employment.

Like many other types of businesses across the U.S., fishing tackle companies must also meet their obligations for various production costs and business taxes which are traditionally related to the manufacturing and sale of a product. But, the application of the ten percent excise tax on fishing tackle shipments, that are earmarked solely for the Dingell-Johnson fund and furthermore, a fund which only the fishing tackle industry pays for, is a special tax in general comparison to vendors of other products. In AFTMA's opinion, the schedule for payment of excise tax can be adjusted to reasonably meet the specific cash flow and operational needs of the industry without endangering the well-being of the trust fund which, as noted earlier, is totally supported by all manufacturers.

AFTMA and the fishing tackle manufacturers whose products are covered by the excise tax seek to amend Section 4161(a) of the Internal Revenue Code of 1954 in regard to the imposition and collection of the ten percent excise tax.

The proposed bill, H.R. 2402, merely seeks to defer the payment of excise tax by the manufacturer for a minimum of 90 days, but not more than 180 days. This bill would require the manufacturer to pay the full amount of excise tax due at the end of the quarter immediately following the quarter in which shipment was made to the vendee. The only exception would be for fourth quarter shipments for which the excise tax will be paid as usual in order to avoid any revenue or budgetary affects on the D-J program. The manufacturer is still totally responsible for the collection and deposit of excise tax, regardless of the status of his receivables at the time when the tax is due under this bill's proposed schedule for payments.

It is AFTMA's strong belief that excise taxes, which are earmarked for specific trust activities, should be imposed in such a way as to effect the least possible distortion in the economic forces governing the production of the items taxed. The proposed bill does not endanger, in any way, the Federal Aid in Fish Restoration program and provides a much needed stimulus for fishing tackle manufacturers to further expand their production, stabilize employment and reduce the inflationary pressure which has resulted from the current requirement to pay excise tax on products shipped well before the payment has been received.

H.R. 2402 is an equitable compromise between maintaining a strong Federal program for conservation and fish restoration and at the same time providing much needed relief for small manufacturers thereby enabling them to further expand their production, stabilize their employment throughout the year and reduce the unnecessary financial pressure which has resulted from the requirement to pay excise tax on shipments in advance of receiving payment from their customers.

Positive action by the 97th Congress to reduce the hardship resulting from premature payment of excise taxes can and will have a dramatic effect on an entire industry, the majority of whom are small businesses.

The proposed legislation is highly important to the fishing tackle industry. Therefore, AFTMA, on behalf of its membership and as a spokesman for the fishing tackle industry, urges that favorable consideration be given to H.R. 2402. AFTMA wishes to thank the members of the Subcommittee for this opportunity to present our views and background information in support of H.R. 2402. We will be happy to answer any questions that you might have.

Mr. DUNCAN. Thank you.

Mr. Kern.

STATEMENT OF DAVE KERN, COMPTROLLER, ZEBCO, TULSA, OKLA., ACCOMPANIED BY DR. RALPH BIEDERMANN, DIRECTOR, CORPORATE RELATIONS, BRUNSWICK CORP.

Mr. **Kern**. I am Dave Kern, comptroller of Zebco, a fishing tackle company located in Tulsa that provides jobs for about 750 people in the manufacture of fishing tackle products.

The issue to us is the timing of the current industry practice that forces us to borrow funds at very high interest rates in order to pay this tax before we collect funds.

Our ability to offer dating is encumbered by the way that the funds are collected at this time.

The importance of dating to the industry is reflected in the fact that it is supporting wholesalers and dealers who in many cases are undercapitalized and who could not otherwise afford to stock adequate supplies of fishing tackle, particularly in the winter months and late fall months when the retail sales are somewhat reduced.

In fact, the increase in dating programs over the years had actually generated increased sales in this period, particularly August through December when it was originally in the 1950's approximately 20 percent of our sales. It is now approaching 40 percent.

This amendment would also smooth production, help us smooth production, lower costs, improve worker stability and benefit the people making the fishing tackle and who are employed here in the United States.

This amendment would make it easier for us to expand dating in periods of economic difficulty when our wholesalers and dealers need the support.

It also reflects reduced costs for the consumer, as Mr. Schedler noted.

The changes that have taken place since the 1950's are that dating has become far more important. Also, interest rates, instead of being 4 percent, are closer to 20.

Indeed, the Treasury Department has accelerated the remittance schedule for these funds. This amendment will correct that timing imbalance and more closely match tax remittance to collections without affecting D–J funding.

In regard to Mr. Chapoton's comments, we would like to confirm that the reduced float will practically be offset by increased income taxes. We do pay a substantially higher rate than Treasury for our funds.

Furthermore, the act never intended that this revenue would be used to fund the general fund of the U.S. Government. Relative to precedents, we believe the only precedent set here is that a small industry has had the foresight to develop and generate funds to increase the industry and to aid the sport-fishing members of our community, thank you, sir.

[The prepared statement follows:]

Statement of Dave Kern, Comptroller, Zebco Division, Brunswick Corp.

SUMMARY

1. The tax is voluntary on the part of the sportfishing industry.
2. ZEBCO has always supported the tax.

3. The tax is important to the development of the sportfishing industry.

4. The calendarization of sales by the industry has changed since the tax was enacted as a result of dating programs.

5. The timing for remittance of the tax has been accelerated.

6. Dating is sometimes more important than price.

7. The acceptance of sales terms affects investment and people.

8. The effect on Treasury is minimal.

9. The provisions of H.R. 2402 more closely match the remittance of the tax with the collection for the sale.

10. It was never intended for the revenue deposited from this small sportfishing industry to fund the United States Treasury for any amount or period of time.

11. The fact that this is an industry-sponsored tax on a voluntary basis makes it unique and the proposed legislation should not be considered special interest or a precedent for any other excise tax interests.

STATEMENT

Mr. Chairman, my name is Dave Kern and I am Comptroller of Zebco, a fishing tackle company located in Tulsa, Oklahoma.

ZEBCO HAS ALWAYS SUPPORTED THE VOLUNTARY TAX OF SPORTFISHING ITEMS TO FUND A FISH RESTORATION PROGRAM

Zebco is one of the companies which initially supported the imposition of an excise tax on our products in 1952 and has never changed its position. The company has always recognized that a development program to promote the sportfishing industry was in its best long-term interest. It is more important now than ever before to attract new participants and to retain the old participants. Perhaps the most critical long-range issue facing the sportfishing industry is the degree of success that a participant has when he goes fishing. A reasonable change of catching fish is increased if there are more lakes and, most important, more fish in those lakes. With the rapid increase in population growth over the past 25 years, it is even more important today that the restoration programs funded from the sale of our own products and taxed on our own initiative be maintained and increased.

FISH RESTORATION PROGRAMS ARE DEPENDENT ON THE GROWTH OF THE SPORTFISHING INDUSTRY

One of the ways to increase the availability of Dingell-Johnson funds is for manufacturers to increase their sales. Historically, the fishing tackle year begins on August 1, with new products, prices and programs, and ends on the following July 31. In 1952, when the legislation and related timing of excise tax payments was enacted, Zebco generated 20 percent of its annual volume from August 1 thru December 31. Marketing tactics designed to get the products on customers' shelves ahead of the normal selling season (January-May) resulted in the practice of offering an extended period of time for payment if the customer would accept delivery ahead of the normal shipping period. Known in the industry as "dating" or "terms", this tactic met with enough success so that by 1960 about 30 percent of Zebco's sales were from August thru December. It was about this period of time that the Japanese began to make some inroads in the United States market. In 1961, to block the cheap imports, Zebco introduced an inexpensive reel identified as the Model 202 and used this reel in a free goods program that required orders to be shipped no later than November 30 in order to qualify for maximum discounts as well as dating. By 1965, over 35 percent of sales were generated in the August thru December period, increasing to over 40 percent in recent years and sold under some form of dating. It is our opinion that this pattern is fairly representative of the sportfishing industry. Zebco not only taught America how to fish, it also taught America how to sell.

THE CALENDARIZATION OF SALES HAS CHANGED AS A RESULT OF DATING PROGRAMS

All this to say that over the years since the excise tax legislation was enacted, the calendarization of sales has changed as a result of programs and promotions which, in turn, has resulted in increased sales. Our experience has been that if the products can be placed in the hands of the customer, he will find a way to move them ahead of the normal selling season also.

DATING IS SOMETIMES MORE IMPORTANT THAN PRICE

Over 50 percent of the sportfishing industry sales were to wholesalers or jobbers who, in turn, must offer dating to their retail customers. This type of outlet historically has been undercapitalized and must receive their money before they can pay us. This is an additional reason why dating is so prevalent in the industry.

THE ACCEPTANCE OF SALES TERMS AFFECTS INVESTMENTS AND PEOPLE

While the primary motive in offering dating is to increase sales and related profits, an important benefit is the leveling of production to make maximum usage of the physical facilities. The same annual volume can be obtained from less investment in property, plant and equipment if production is relatively even for month-to-month rather than producing at an accelerated pace for a few months of the year.

The same benefit to property, plant and equipment from leveling of production is also related to the financial costs of building inventory ahead to meet peak shipping periods and trust that the demand will still be there at the seasonal peaks. However, the greatest benefit of more level production is to our production workers. A stabilized work force is not only more profitable to the company but is equally more desirable from our workers' standpoint.

EFFECT ON THE U.S. TREASURY

Senator Durenberger in his remarks to the Senate when he introduced S. 710, the companion bill to H.R. 2402, stated the effect on Treasury and the position of the Industry as well. "The government will lose only minimal interest income on this proposal, but it is much more equitable to those who voluntarily pay this tax to move toward regulatory reform. In fact, the Regulatory Flexibility Act directs us to find ways to reduce Government regulation of small business. This is a classic case where we can apply that principle. The alternative is to watch the economic burden mount on these small business people, their employees and then on the thousands of bait and tackle shops served by this industry. I urge you to join me in supporting this measure."

Since the U.S. Treasury acts as a collection agency, it is granted that they would be denied use of the funds for the period of the deferral. However, it was never the intent for the cash flow from voluntary, self-imposed excise taxes on this small fishing tackle industry to fund the Treasury for any period of time.

On September 30, 1980, Donald Lubick wrote to Congressman Jim Jones a letter stating that this legislation would cost the U.S. Treasury one million dollars per year for interest on additional borrowings. Mr. Lubick documented only part of the facts, (not unusual). In his letter, he based his computation on an estimate of collections of $38.9 million for the fiscal year 1981. The amount of excise tax collections for 1981 on fishing reels, rods, etc., is reported at $31.9 million. A margin of error of 18 percent, (again, not too unusual). Therefore, Mr. Lubick's position should have been an effect of $820,000 on Treasury.

The other side of the story is that if it costs Treasury $820,000 at Treasury bill rates, the fishing tackle manufacturers are borrowing at least at 150 percent of those rates, (probably closer to 200 percent for most of the industry). Using Treasury's own analysis, interest expense to the Treasury would become income to the fishing tackle manufacturers but at 150 percent of the amount in question. Therefore, Mr. Lubick should have offset the $820,000 additional income taxes collected on a quarterly basis from the fishing tackle manufacturers from increased profits of $1,230,000, (probably closer to $1.6 million).

COMPUTATION (INCOME (EXPENSE))

	Treasury	Manufacturer
Effect of this bill	($820,000)	$1,230,000
Income taxes (50 percent)	615,000	(615,000)
Total	205,000	615,000

The Treasury Department testified on April 23, 1982, on S. 710, (companion bill to H.R. 2402), that there was "no revenue effect". Another important point is the deflationary effect on fishing tackle items if this bill were passed. Prices could be maintained, whereas the present system is inflationary and requires the fishing tackle manufacturers to borrow the money to pay the tax before collection for the sale is made. These costs find their way into the selling price of the products and are marked up throughout the distribution system.

SUMMARY

The method of selling and the subsequent collection of receivables has changed since the industry voluntarily imposed an excise tax on its products. The timing for remittance of the tax has even been increased. The provisions of the proposed legislation would enable the manufacturer or importer to more closely match the payment of the tax with the collection for the sale which was the intent in 1952. Therefore, the proposed legislation should not be considered special interest or a precedent for any other excise tax interests.

Chairman **STARK**. Thank you, Mr. Kern.

Mr. O'Connell, you may proceed.

STATEMENT OF FRANK O'CONNELL, LEGISLATIVE DIRECTOR AND INTERNATIONAL VICE PRESIDENT, TRANSPORT WORKERS UNION, AFL-CIO

Mr. **O'CONNELL**. I am Francis A. O'Connell, international vice president and director of legislation for the Transport Workers Union of America, AFL-CIO, with offices at 100 Indiana Avenue NW., Washington, D.C.

I am here today on behalf of the 400 employees TWU represents at Zebco, a fishing reel manufacturer in Tulsa, Okla.

TWU supports the adoption of H.R. 2402, one of the measures the committee has under consideration, which was introduced by Congressman Jones.

The history of the manufacturer's excise tax on fishing tackle equipment, as I understand it, is that in 1952 the industry itself advocated legislation to impose a tax and allocate the funds generated from such tax for conservation and fish restoration programs.

I also understand that over the years the industry has changed its method of selling fishing tackle so that shipments are no longer concentrated in a few months, just prior to the heavy fishing season. Promotion and pricing programs have successfully spread sales over a greater number of months.

Steady production and shipping timetables mean steady employment to the assembly worker. The closer a company can come to leveling its production throughout the year, the more stabilized its work force becomes.

Many companies, including Zebco, increase their work forces and build inventory ahead in anticipation of the shipping season, only to have mass layoffs at its conclusion.

We, as one union representing these assembly workers, favor increased ability on management's part, which would guarantee a more stable employment status for the worker.

Seasonal work in some industries cannot be controlled, such as in agriculture and construction, but when a situation exists which artificially creates seasonal work and a change can be made, such change should be made.

We believe the excise tax payment schedule, which requires the manufacturer to pay the tax upon shipment of goods rather than when such goods are paid for by the wholesaler or retailer, sets up an artificial seasonal work force in the fishing tackle industry.

If the payment of the excise tax is rescheduled to coincide with payment for goods delivered, then companies such as Zebco could go on a year-round production schedule.

The provisions of H.R. 2402 would allow for full-time year-round production. This, in turn, would guarantee a stable work force—an important benefit for the assembly worker.

TWU supports the proposed legislation, H.R. 2402, and urges its adoption by this committee.

That concludes my printed statement, Mr. Chairman, but I would like to make a couple of additional comments.

Zebco has two separate manufacturing plants in Tulsa, and employs approximately 750 of whom we, TWU, represent approximately 400 assembly line, packaging and warehouse employees.

While I cannot speak for the full 750 employees, all will benefit immensely by passage of H.R. 2402.

May I also add, Zebco is the last major manufacturer of fishing reels in the entire United States. I suppose this is because Zebco produces a fine product covering the full range of fishing reels and rods, from the very cheapest to perhaps the most expensive, and we don't wish to see Zebco go by the boards as a result of competition from foreign-made and imported fishing reels and tackle manufactured with cheap labor, which we fear is very likely to occur unless Zebco gains the relief contained in this legislation.

Mr. Chairman, may I also add, nearly 95 percent of Zebco's employees are women—mothers, housewives, and homemakers; many are the sole wage earner in the family, in many cases head of the household.

TWU urges favorable consideration of this legislation once again by the committee. Thank you, Mr. Chairman.

Chairman STARK. Thank you, Mr. O'Connell. I want to thank the panel for their participation.

Mr. Duncan.

Mr. DUNCAN. I have no questions, thank you, Mr. Chairman.

Chairman STARK. Thank you.

The subcommittee will recess until 2 o'clock this afternoon and it will resume sitting in H-137.

[Whereupon, at 1:20 p.m., the hearing was adjourned.]

APPENDIX

The text, summary, and written comments received on bills which are the subject of this hearing follow.

DEFINITION OF ARTIFICIAL BAIT FOR PURPOSES OF THE EXCISE TAX ON FISHING EQUIPMENT

97TH CONGRESS
1ST SESSION

H. R. 617

To amend the Internal Revenue Code of 1954 to provide for a definition of the term "artificial bait".

IN THE HOUSE OF REPRESENTATIVES

JANUARY 5, 1981

Mr. ROUSSELOT (for himself and Mr. LEWIS) introduced the following bill; whicl was referred to the Committee on Ways and Means

---

A BILL

To amend the Internal Revenue Code of 1954 to provide for a definition of the term "artificial bait".

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 4161 of the Internal Revenue Code of 1954 (relating to imposition of tax on sporting goods) is amended by adding at the end of thereof the following: "*Provided,* That the term 'artificial bait' as used in the preceding sentence shall not include any substance which contains 85 percent or more by weight of plant or animal material which can be ingested by fish.".

(b) The amendment made by subsection (a) shall apply to sales after December 31, 1979.

○

Summary and Description

PRESENT LAW

Under present law, a 10-percent excise tax is imposed upon the sales price of fishing rods, creels, and reels, and on artificial lures, baits, and flies (including parts or accessories of such articles sold on or in connection therewith, or with the sale thereof) by the manufacturer, producer, or importer (sec. 4161 (a)).

There is no statutory definition of "artificial bait" to which the tax applies. However, Treasury Regulations (Treas. Reg. § 48.4161(a)-2(d)) define the term "artificial lures, baits, and flies" to include all artifacts, of whatever materials made, that simulate an article considered edible to fish, and that are designed to be attached to a line or hook to attract fish so that they may be captured. Thus, the term includes such artifacts as imitation flies, blades, spoons, spinners, etc., and edible materials that have been processed so as to resemble a different edible article considered more attractive to fish, such as bread crumbs treated so as to simulate salmon eggs, and pork rind cut and dyed to resemble frogs, eels, or tadpoles.

The Internal Revenue Service has taken the position that bait which contains very little artificial substance may be subject to the excise tax. In Revenue Ruling 71-321, 1971-2 C.B. 369, the Service held that edible food items which are shaped or treated to give the appearance or odor of insects, flies, worms, frogs, etc., are artificial lures or baits. In addition, in Revenue Ruling 77-302, 1977-2 C.B.374, the Service held that a floating fish bait that is manufactured from a semi-soft cheese food to which ingredients are added to provide the desired consistency, color, scent, and buoyancy and which is then packaged by weight and sold in a solid form that the user may shape or form, as with a fish hook, is an artificial bait or lure subject to the manufacturer's excise tax.

ISSUE

The issue is whether certain substances should be excluded from the term "artificial bait," for purposes of the excise tax.

EXPLANATION OF THE BILL

This bill would exclude from the definition of "artificial bait" any substance which contains 85 percent or more by weight of plant or animal material which can be ingested by fish. Thus, those types of substances would be exempt from the 10-percent tax.

Although this provision may benefit other taxpayers, it is intended primarily to benefit the Don Rich Company, Inc., of La Canada, California, which produces "Zeke's Floatin' Bait." This bait has a base of processed cheese to which is added certain artificial ingredients which make the cheese easier to thin and mix and which give the bait its floatation characteristics.

EFFECTIVE DATE

The bill would apply with respect to sales made after December 31, 1979.

REVENUE EFFECT

It is estimated that this bill would reduce budget receipts by a negligible amount.

POSTPONEMENT OF TIME FOR PAYING EXCISE TAX ON FISHING EQUIPMENT

97TH CONGRESS
1ST SESSION

H. R. 2402

To amend the Internal Revenue Code of 1954 to change the period for the payment of taxes under section 4161(a) of such Code.

IN THE HOUSE OF REPRESENTATIVES

MARCH 10, 1981

Mr. JONES of Oklahoma introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To amend the Internal Revenue Code of 1954 to change the period for the payment of taxes under section 4161(a) of such Code.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. Section 6302 of the Internal Revenue Code of 1954 (relating to mode or time of collecting tax) is amended by adding at the end thereof the following new subsection:

"(d) TIME FOR PAYMENT OF MANUFACTURERS' EXCISE TAX ON RODS, CREELS, ETC.—The tax imposed by section 4161(a) (relating to manufacturers' excise tax on rods, creels, etc.) shall be due and payable—

"(1) in the case of articles sold during the quarter ending December 31, on March 31,

"(2) in the case of articles sold during the quarter ending March 31, on June 30,

"(3) in the case of articles sold during the quarter ending June 30, on September 24, and

"(4) in the case of articles sold during the quarter ending September 30, at such time as the Secretary may by regulations prescribe.".

SEC. 2. The amendment made by the first section of this Act shall apply to articles sold on or after October 1, 1981.

SUMMARY AND DESCRIPTION

Under present law, a 10-percent excise tax is imposed upon the sales price of fishing rods, creels, and reels, and on artificial lures, baits, and flies (including parts or accessories of such articles sold on or in connection therewith, or with the sale thereof) by the manufacturer, producer, or importer (sec. 4161(a)).

Treasury regulations require returns of manufacturers excise taxes, including the tax on the sale of fishing equipment, to be filed quarterly, unless the Internal Revenue Service requires more frequent filing by an individual taxpayer (Treas. Reg. § 48.6011(a)-1). Quarterly returns are due on the last day of the first month after the quarter ends (Treas. Reg. § 48.6071(a)-1).

Although returns generally are filed on a quarterly basis, the regulations require monthly, or semimonthly, payment of the tax in certain cases (Treas. Reg. § 48.6302(c)-1). If an individual is liable in any month for more than $100 of manufacturers excise tax and is not required to make semimonthly deposits, the individual must deposit the amount on or before the last day of the next month at an authorized depository or at the Federal Reserve Bank serving the area in which the individual is located.

If an individual had more than $2,000 in manufacturers excise tax liability for any month of a preceding calendar quarter, such taxes for the following quarter must be deposited (regardless of amount) on a semimonthly basis. The taxes must be deposited by the ninth day following the semimonthly period for which they are deposited. In addition, if the semimonthly period is in either of the first two months of the quarter, any underpayment of excise taxes for a month must be deposited by the ninth day of the second month following such month. Underpayments in the third month of the quarter must be deposited by the end of the following month.

No special rules are provided to defer payment of the excise tax with respect to sales of taxable articles on credit.

ISSUE

The issue is whether the time for payment of the excise tax imposed on the sale of fishing equipment should be postponed.

EXPLANATION OF THE BILL

The bill would amend present law to require payment of the excise tax on fishing equipment on a quarterly basis, as follows: (1) March 31, in the case of articles sold during the quarter ending the previous December 31; (2) June 30, in the case of articles sold during the quarter ending the previous March 31; (3) September 24, in the case of articles sold during the quarter ending the previous June 30; and (4) On a date prescribed in Treasury regulations in the case of articles sold during the quarter ending September 30.

The bill would not change the present time for filing returns of manufacturers excise taxes or the time for payment of such taxes on articles other than fishing equipment.

EFFECTIVE DATE

The provisions of the bill would apply to fishing equipment sold by manufacturers, producers, or importers on or after October 1, 1981.

REVENUE EFFECT

The bill would not affect the aggregate fiscal year receipts of the manufacturers excise tax on fishing equipment.

OTHER CONGRESSIONAL ACTION

A similar provision passed the House in the 96th Congress (sec. 7 of H.R. 5505). Also, a similar provision is contained in the Senate Finance Committee amendment to H.R. 4961, approved on July 2, 1982.

STATEMENT OF HON. JAMES R. JONES, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

Mr. Chairman and Members of this Subcommittee, I wish to thank you for the opportunity to make a statement on behalf of H.R. 2402, which I am cosponsoring along with Congressmen Pickle, Vander Jagt, Hagedorn, and Bailey.

This legislation should be very familar to Members of this Subcommittee. It was passed by the House in the 96th Congress and is part of the Senate Finance Committee bill, H.R. 4961, as amended.

H.R. 2402 attempts to deal with the unique situation faced by fishing tackle manufacturers, the vast majority of whom are small businesses. This industry pays a ten-percent excise tax on fishing tackle and related equipment, the proceeds of which go into a trust fund used for conservation and fish restoration. Under current law, this excise tax must be paid on a semi-monthly basis, within nine days after the close of the semi-monthly period in which the delivery of the taxable item occurred.

The problem, Mr. Chairman, is quite simple. The fishing tackle industry is seasonal in nature, and during certain times of the year, it must sell its goods on consignment in order to avoid seasonal layoffs of employees. This has been a long-standing practice, and one that has only become a problem in recent times with high interest rates and tight money. In effect, fishing tackle manufacturers are liable for the excise tax before they have an opportunity to collect their payments from consignees.

This is a particularly ironic situation, since the fishing tackle industry has supported the excise tax as a proper method of funneling needed funds into wildlife and conservation projects.

Consequently, the legislation before the Subcommittee would merely stretch-out the time of payment for the excise tax so as to conform to the peculiar market conditions of the fishing tackle industry.

This legislation, Mr. Chairman, defers taxes, it does not forgive them. No revenue need be lost because of the passage of the bill. As it is currently drafted, the bill would allow manufacturers to stretch-out the payment of the excise tax a minimum of 90 days, and a maximum of 180 days. In the case of articles sold during the quarter ending September 30, payments will be made at such time as the Secretary of the Treasury may prescribe by regulations.

From all available data, Mr. Chairman, the fishing tackle industry is one of a handful of industries with seasonal fluctuations in their sales. More importantly, the sole reason they are asking for assistance is because of the whims of Mother Nature, which make our rivers and streams freeze over, and turn a fisherman's legs blue, should he venture out into inhospitable waters during those cold winter months.

Mr. Chairman, the bill before the Subcommittee is not some veiled attempt to give an industry a tax break. It is nothing more than simple justice and it should cost us nothing. I urge the Subcommittee to approve this bill.

TAX EXEMPTION FOR INDUSTRIAL DEVELOPMENT BONDS FOR FACILITIES FOR THE LOCAL FURNISHING OF GAS

97TH CONGRESS
1ST SESSION

H. R. 4917

To amend the Internal Revenue Code of 1954 to clarify the local furnishing rule with respect to the tax-exempt status of interest on obligations issued to provide facilities for the local furnishing of gas.

IN THE HOUSE OF REPRESENTATIVES

NOVEMBER 5, 1981

Mr. RANGEL introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To amend the Internal Revenue Code of 1954 to clarify the local furnishing rule with respect to the tax-exempt status of interest on obligations issued to provide facilities for the local furnishing of gas.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) the last sentence of paragraph (4) of section 103(b) of the Internal Revenue Code of 1954 (relating to industrial development bonds) is amended by inserting "or gas" after "electric energy".

(b) The amendment made by subsection (a) shall apply to obligations issued after the date of the enactment of this Act.

SUMMARY AND DESCRIPTION

PRESENT LAW

Under present law, interest on State and local government obligations is generally exempt from Federal income tax. However, tax exemption generally is denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax exemption for interest on IDBs applies in the case of IDBs which are used to provide certain exempt activity facilities. Such facilities include facilities for the local furnishing of electric energy and gas (sec. 103(b)(4)(E)).

A facility for the furnishing of electric energy or gas is defined in Treasury regulations as property for the furnishing of electric energy or gas which is part of a system providing service to the general populace in a service area comprising no more than two contiguous counties. (Treas. Reg. § 1.103-8(f)(2)(iii)(d)). In the Revenue Act of 1978, the definition of a facility for the local furnishing of electric energy was modified to also include property for the furnishing of electric energy which is part of a system which provides electric energy to the general populace in a service area comprising no more than a city and one contiguous county.

ISSUE

The issue is whether the definition of a facility for the local furnishing of gas should be amended to include a facility for the furnishing of gas which is part of a system which provides service to the general populace in an area comprising no more than two contiguous counties or a city and one contiguous county.

EXPLANATION OF THE BILL

The bill provides that the local furnishing of gas from a facility would include the furnishing solely within an area comprised of a city and one contiguous county. Thus, under the bill, tax-exempt financing would be made available in the case of a facility for the furnishing of gas (which otherwise meets the requirements of sec. 103) provided that the service area of the facility comprised no more than two contiguous counties or a county and one contiguous city.

The principal beneficiaries of the bill would be the Brooklyn Union Gas Company and the Consolidated Edison Corporation.

EFFECTIVE DATE

The bill would apply to obligations issued after the date of enactment.

REVENUE EFFECT

It is estimated that the bill would reduce budget receipts by $2 million in fiscal year 1983, $5 million in 1984, $8 million in 1985, $12 million in 1986 and $15 million in 1987.

OTHER CONGRESSIONAL ACTION

A similar provision is contained in the Senate Finance Committee amendment to H.R. 4961, approved on July 2, 1982.

REDUCTION OF CERTAIN WITHHOLDING TAXES PAID TO THE VIRGIN ISLANDS, AND SEPARATE APPLICATION OF FOREIGN TAX CREDIT

97TH CONGRESS
2D SESSION

H. R. 5985

To amend the Internal Revenue Code of 1954 to reduce the rate of certain taxes paid to the Virgin Islands on Virgin Islands source income, to provide that the foreign tax credit shall be applied separately with respect to taxes paid or deemed paid to the Virgin Islands, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

MARCH 30, 1982

Mr. DE LUGO (for himself, Mr. HOLLAND, Mr. HEFTEL, and Mr. SCHULZE) introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To amend the Internal Revenue Code of 1954 to reduce the rate of certain taxes paid to the Virgin Islands on Virgin Islands source income, to provide that the foreign tax credit shall be applied separately with respect to taxes paid or deemed paid to the Virgin Islands, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. REDUCTION IN INCOME TAX RATE ON VIRGIN ISLANDS SOURCE INCOME.

(a) In General.—Subpart D of part III of subchapter N of chapter 1 of the Internal Revenue Code of 1954 (relating to possessions) is amended by inserting after section 934 the following new section:

"SEC. 934A. REDUCTION IN INCOME TAX RATE ON VIRGIN ISLANDS SOURCE INCOME.

"(a) General Rule.—For purposes of determining the tax liability incurred to the Virgin Islands pursuant to this title with respect to amounts received from sources within the Virgin Islands, the rate of the taxes imposed by sections 871(a)(1) and 881 shall not exceed 10 percent.

"(b) Further Reductions Permitted.—Subsection (a) of section 934 shall not apply to the taxes imposed by sections 871 and 881.

"(c) Reduced Rates Not to Apply to Pre-Effective Date Earnings.—

"(1) In general.—The reduction under subsection (a), and any reduction under section 934 pursuant to subsection (b), in a rate of tax imposed by section 871 or 881 shall not apply to dividends paid out of earnings and profits accumulated before the effective date of the reduction.

"(2) Ordering rule.—For purposes of paragraph (1), dividends shall be treated as first being paid out of earnings and profits accumulated before the effective date of the reduction (to the extent thereof)."

(b) WITHHOLDING.—Subchapter A of chapter 3 of such Code (relating to withholding of tax on nonresident) is amended by adding at the end thereof the following new section:

"SEC. 1444. WITHHOLDING ON VIRGIN ISLANDS SOURCE INCOME.

"For purposes of determining the withholding tax liability incurred to the Virgin Islands pursuant to this title with respect to amounts received from sources within the Virgin Islands, the rate of withholding tax under sections 1441 and 1442 on income subject to tax under sections 871 and 881 shall not exceed the rate of tax on such income under sections 871 and 881."

(c) TECHNICAL AMENDMENT.—Subsection (a) of section 934 of such Code is amended by inserting before the period at the end thereof "or in section 934A".

(d) CLERICAL AMENDMENTS.—

(1) The table of sections for subpart D of part III of subchapter N of chapter 1 of such Code is amended by inserting after the item relating to section 934 the following:

"Sec. 934A. Reduction in income tax rate on Virgin Islands source income."

(2) The table of sections for subchapter A of chapter 3 of such Code is amended by adding at the end thereof the following new item:

"Sec. 1444. Withholding on Virgin Islands source income."

(e) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to amounts received after the date of the enactment of this Act in taxable years ending after such date.

(2) WITHHOLDING.—The amendment made by subsection (b) shall apply to payments made after the date of the enactment of this Act.

SEC. 2. PER COUNTRY LIMITATION FOR TAXES PAID OR DEEMED PAID TO THE VIRGIN ISLANDS.

(a) IN GENERAL.—Subpart D of part III of subchapter N of chapter 1 of the Internal Revenue Code of 1954 (relating to possessions) is amended by inserting after section 934A the following new section:

"SEC. 934B. PER COUNTRY LIMITATION FOR TAXES PAID OR DEEMED PAID TO THE VIRGIN ISLANDS.

"(a) ALLOWANCE OF CREDIT.—

"(1) IN GENERAL.—If the taxpayer chooses to have the benefits of subpart A of this part and elects the application of this section, there shall be allowed as a credit against the tax imposed by this chapter for the taxable year the sum of—

"(A) the Virgin Islands withholding taxes paid or accrued during such taxable year, and

"(B) the deemed paid Virgin Islands taxes for such taxable year.

"(2) ELECTION OF SECTION.—The election to have this section apply for any taxable year may be made or changed at any time before expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year.

"(b) TAXPAYERS ALLOWED CREDIT.—

"(1) VIRGIN ISLANDS WITHHOLDING TAXES.—

"(A) IN GENERAL.—The credit allowable by subsection (a) for Virgin Islands withholding taxes shall be allowed only in the case of a citizen or resident of the United States, a domestic corporation, or an individual who is a bona fide resident of Puerto Rico during the entire taxable year.

"(B) PARTNERSHIPS AND ESTATES.—In the case of an individual described in subparagraph (A), rules similar to the rules of section 901(b)(5) shall apply to Virgin Islands withholding taxes.

"(2) DEEMED PAID VIRGIN ISLANDS TAXES.—The credit allowable by subsection (a) for deemed paid Virgin Islands taxes shall be allowed only in the case of a domestic corporation.

"(3) NONRESIDENT ALIEN INDIVIDUALS AND FOREIGN CORPORATIONS.—Rules similar to the rules of section 906 shall apply to Virgin Islands withholding taxes and deemed paid Virgin Islands taxes.

"(c) DEFINITIONS.—For purposes of this section—

"(1) VIRGIN ISLANDS WITHHOLDING TAXES.—The term 'Virgin Islands withholding taxes' means any tax imposed by section 871(a)(1) or 881 and paid or accrued to the Virgin Islands.

"(2) DEEMED PAID VIRGIN ISLANDS TAXES.—The term 'deemed paid Virgin Islands taxes' means the amount determined under section 902 taking into account only—

"(A) accumulated profits from Virgin Islands source income and dividends paid therefrom, and

"(B) taxes paid or deemed to be paid by the foreign corporation to the Virgin Islands.

"(d) LIMITATIONS.—

"(1) MAXIMUM CREDIT FOR VIRGIN ISLANDS WITHHOLDING TAXES.—The credit allowed by subsection (a) for Virgin Islands withholding taxes for the taxable year shall not exceed the tax imposed by this chapter for such taxable year reduced by the sum of—

"(A) the credit allowed by section 33 for such taxable year, plus

"(B) the credit allowed by subsection (a) for deemed paid Virgin Islands taxes for such taxable year.

"(2) MAXIMUM CREDIT FOR DEEMED PAID VIRGIN ISLANDS TAXES.—

"(A) IN GENERAL.—The credit allowed by subsection (a) for deemed paid Virgin Islands taxes to any domestic corporation for the taxable year shall not exceed the lesser of—

"(i) the Virgin Islands source income limitation of such corporation for such taxable year, or

"(ii) the tax imposed by this chapter for such taxable year reduced by the credit allowed by section 33 for such year.

"(B) VIRGIN ISLANDS SOURCE INCOME LIMITATION.—For purposes of subparagraph (A)(i), the term 'Virgin Islands source income limitation' means, with respect to a domestic corporation for a taxable year, an amount which bears the same ratio to the amount determined under subparagraph (A)(ii) for such taxable year as—

"(i) the sum of—

"(I) the taxable income of such corporation, computed by taking into account only dividends taken into account in computing the deemed paid Virgin Islands taxes for such taxable year, and

"(II) amounts treated as dividends under section 78 for such taxable year with respect to dividends described in subclause (I), bears to

"(ii) the entire taxable income of such corporation for such taxable year.

"(3) TAX IMPOSED BY THIS CHAPTER.—For purposes of this section, the tax imposed by this chapter shall not include any tax against which the credit allowable by section 33 may not be allowed by reason of the third sentence of section 901(a).

"(e) CARRYOVERS.—

"(1) VIRGIN ISLANDS WITHHOLDING TAXES.—Rules similar to the rules of section 904(c) shall apply in any case where the Virgin Islands withholding taxes paid or accrued during a taxable year exceed the limitation under subsection (d)(1) for the taxable year.

"(2) DEEMED PAID VIRGIN ISLANDS TAXES.—Rules similar to the rules of section 904(c) shall apply in any case where the deemed paid Virgin Islands taxes for the taxable year exceed the limitation under subsection (d)(2) for the taxable year.

"(3) SPECIAL RULES.—For purposes of this subsection—

"(A) CARRYOVERS NOT REDUCED WHERE SECTION NOT ELECTED FOR CARRYOVER TAXABLE YEAR.—In the case of a carryover to a taxable year for which the taxpayer did not elect the application of this section, the limitation under paragraph (1) or (2) of subsection (d), as the case may be, shall be treated as being zero but such year shall nonetheless be counted in determining the number of years to which such unused credit may be carried.

"(B) CARRYBACKS NOT ALLOWED FOR PRE-EFFECTIVE YEARS.—No carryback from an unused credit year ending after the date of the enactment of this section may be carried to a taxable year ending before the date of the enactment of this section.

"(f) OTHER SPECIAL RULES.—

"(1) COORDINATION WITH SECTION 901.—If the taxpayer elects the application of this section for a taxable year, no amount for which a credit is allowable under this section shall be allowed as a credit under section 901 for such taxable year or for any taxable year to which any portion of such amount is a carryback or carryover.

"(2) COORDINATION WITH SECTION 904.—For purposes of section 904(a), in the case of a taxpayer who elects the application of this section for a taxable year—

"(A) taxable income shall not include—

"(i) taxable income with respect to which tax may be imposed by the Virgin Islands under section 871(a)(1) or 881, and

"(ii) amounts described in subsection (d)(2)(B)(i)(II), and

"(B) the tax against which the credit described in section 901(a) is taken shall be determined as though taxable income did not include amounts described in subparagraph (A)."

(b) CLERICAL AMENDMENT.—The table of sections for subpart D of part III of subchapter N of chapter 1 of such

Code is amended by inserting after the item relating to section 934A the following:

"Sec. 934B. Per country limitation for taxes paid or deemed paid to the Virgin Islands."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years ending after the date of the enactment of this Act.

SUMMARY AND DESCRIPTION

PRESENT LAW

Virgin Islands taxation in general.—In the Virgin Islands, the U.S. Internal Revenue Code is generally applied as a local territorial tax code, except that tax proceeds are paid into the treasury of the Virgin Islands. In applying the Internal Revenue Code in the Virgin Islands, the name "Virgin Islands" is generally substituted for the name "United States" wherever it appears in the U.S. Code. Some court decisions and IRS documents refer to this system of taxation as a "mirror image" system.

Corporate and individual "inhabitants" of the Virgin Islands are taxed on their worldwide income by the Virgin Islands and are exempt from any income tax liability to the Federal Treasury, even on their U.S.-source income. All corporations chartered in the Virgin Islands are considered to be inhabitants of the Virgin Islands. In certain circumstances, a United States corporation may also qualify as an inhabitant of the Virgin Islands.

The U.S. Internal Revenue Code limits the power of the Virgin Islands government to grant relief from its income tax (sec. 934). The Virgin Islands may not grant rebates for taxes attributable to income derived from sources within the United States. With respect to non-U.S. source income, the Virgin Islands may not grant corporate tax rebates except to U.S. and V.I. corporations that meet a so-called "80-50 test." This test allows the Virgin Islands to grant tax rebates to only those U.S. and V.I. corporations that have derived for the past three taxable years (or applicable part thereof) at least 80 percent of their gross income from V.I. sources and at least 50 percent of their gross income from the active conduct of a trade or business within the Virgin Islands. Acting within the constraint of the 80–50 test, the Government of the Virgin Islands has established further criteria for tax rebates, such as a $50,000 minimum investment and certain employment criteria.

Taxation of passive income in the Virgin Islands.—U.S. law generally imposes a 30-percent tax on the gross amount of dividends, interest, royalties, and other passive investment income paid by U.S. persons to non-resident aliens and foreign corporations when that income is not effectively connected with the conduct of a U.S. trade or business by the foreign person. This 30-percent rate is often reduced, or eliminated, by income tax treaties. U.S. law also generally imposes on the payor of such passive investment income a duty to withhold the tax due (secs. 1441 and 1442).

Under the mirror system, the Virgin Islands imposes a similar 30-percent tax on passive investment income paid by V.I. persons to non-V.I. persons, including U.S. persons. The Virgin Islands cannot now forgive this tax, since the tax is upon the recipient and not upon the company operating in the Virgin Islands. A U.S. recipient of passive income from the V.I. may generally take a foreign tax credit for any such tax (subject to limits) against its U.S. tax liability. Although there is some dispute about the underlying tax liability of the recipient of passive investment income from the Virgin Islands, it is the Internal Revenue Service's position that the recipient is liable for the tax (Rev. Rul. 78–327, 1978–2 C.B. 196).[1]

In addition, there is a dispute about the authority of the Virgin Islands to withhold this tax (as opposed to the authority to impose the underlying tax). This dispute has been the subject of litigation. The U.S. Court of Appeals for the Third Circuit held that the Virgin Islands did not have the power to withhold this tax.[2] The basis of this decision was a Treasury Regulation that provided that U.S. persons were not required to withhold on payments of passive investment income to V.I. persons: the Third Circuit mirrored that regulation to hold that V.I. persons did not have to withhold on payments to U.S. persons. The Treasury Department has since revoked the underlying Regulation. Therefore, according to the IRS, V.I. persons who pay passive investment income to U.S. persons must withhold tax at a 30-percent rate. However, some persons have questioned the validity of the IRS revocation of that underlying Regulation. The revocation occurred simultaneously with issuance of a Revenue Procedure that continued the rule that U.S. persons need not withhold on payments of passive investment income to V.I. persons. Therefore, some persons allege that the revocation of the Regulation was a sham and that the Virgin

---

[1] No inference should be drawn from this discussion as to the correctness of the view of either party about this dispute or about the dispute as to the related withholding obligation.

[2] *Vitco* v. *Government of the Virgin Islands,* 560 F. 2d 180 (3d Cir. 1977), *cert. denied,* 435 U.S. 1980 (1978).

Islands does not have the power to require withholding of the tax. It is understood that these issues are again in controversy.

Guamanian taxation of passive income.—Like the Virgin Islands, Guam is a possession of the United States and has a tax system generally mirroring the Internal Revenue Code. Until 1972, passive investment income paid by Guamanian persons to U.S. persons was subject to a 30-percent Guamanian tax. As is the case with V.I. taxes today, this tax was creditable (subject to limits) against U.S. tax liability through the foreign tax credit mechanism. In 1972, finding that the effect of the Guamanian passive income tax had been to discourage U.S. investment in Guam, Congress repealed the tax.[3]

Foreign tax credit.—U.S. citizens, residents, and corporations are generally taxable on their worldwide income. To avoid double taxation of foreign income, U.S. persons may generally take a credit against their Federal income tax liability for the amount of foreign income taxes paid on income from sources outside the United States. Foreign taxes include taxes paid to the Virgin Islands and other possessions of the United States.

A so-called deemed-paid foreign tax credit is allowed when a foreign corporation distributes a dividend to a U.S. corporation that owns at least 10 percent of the voting stock of the foreign corporation (sec. 902). Such dividends carry with them, for the purpose of the U.S. foreign tax credit, a proportionate amount of foreign taxes paid by the foreign corporation. Foreign corporations include corporations organized in the possessions, including the Virgin Islands.

Since 1921, the tax law has limited the use of foreign tax credits so as to prevent such credits from offsetting U.S. tax on U.S. source income. The foreign tax credit is limited under an overall limitation so that it can offset U.S. tax only on worldwide foreign source income. Under this overall limitation, the amount of foreign tax credits which a taxpayer can apply against its U.S. tax liability on its worldwide income is limited to its U.S. tax liability multiplied by a fraction the numerator of which is worldwide taxable income from sources (including V.I. sources) outside the United States and the denominator of which is worldwide taxable income. Under this limitation, the taxpayer thus aggregates its income and taxes from all foreign countries, including the Virgin Islands. A taxpayer may credit taxes from any foreign country as long as the total amount of foreign taxes applied as a credit in each year does not exceed the amount of tax that the United States would impose on the taxpayer's foreign source income. In cases where the limitation on foreign tax credits reduces the amount of tax that can be used by the taxpayer to offset U.S. tax liability in any one year, the excess credits not used may be carried back for two years and carried forward for five years.

ISSUES

The principal issue is whether the 30-percent Virgin Islands tax on payments of passive investment income by V.I. persons to non-V.I. persons should continue or be reduced by statute. A related issue is whether the V.I. Government should have the discretion to further reduce any remaining tax. Another related issue is whether any reduction in tax should be limited to payments by V.I. persons to U.S. persons. A final issue is whether certain foreign taxes should be allowed to offset U.S. tax on U.S. source income, thus effecting a direct transfer of U.S. revenues to the taxpayer.

EXPLANATION OF THE BILL

Limitation of tax rate on passive investment income to 10 percent.—The bill would generally limit the Virgin Islands tax on amounts received by non-V.I. persons from sources within the Virgin Islands, such as interest, dividends, rents, and other passive investment income which is not effectively connected with the conduct of a trade or business in the Virgin Islands to 10 percent of the gross amount received. The bill would continue the current 30-percent rate for dividends paid out of earnings and profits accumulated before the effective date. It would treat post-effective date dividends as first coming out of pre-effective date profits.

The bill would allow the Government of the Virgin Islands, in its discretion, further to reduce this 10 percent rate (or to eliminate the tax altogether). The Government of the Virgin Islands would have the discretion to reduce (or eliminate) the tax on the basis of criteria it chose. The bill would also limit the complementary withholding tax on such income to the reduced 10 percent (or lower) rate.

---

[3] Congress' method of repealing the Guamanian tax was to repeal the 30-percent U.S. tax on passive investment income paid by U.S. persons to Guamanian persons. Repeal of the Guamanian tax thus occurred through "mirroring" of repeal of the U.S. tax.

The bill would make clear the Virgin Islands' right both to impose the tax and to collect it by requiring withholding.

Separate limitation on the foreign tax credit attributable to Virgin Islands taxes.—The bill would allow a foreign tax credit for certain Virgin Islands taxes to offset U.S. tax on U.S. source income. The bill would create an elective alternative to the current overall foreign tax credit limitation. Upon election, the taxpayer's credit for V.I. taxes paid would consist of two elements: a credit for V.I. withholding taxes and a deemed-paid foreign tax credit for V.I. taxes paid by a subsidiary.

The credit for V.I. withholding taxes could offset U.S. tax on income from U.S. sources. This would be intended to create an additional incentive to investment in the Virgin Islands to those taxpayers whose foreign tax credits already eliminate U.S. tax on their foreign income.

The credit for Virgin Islands deemed paid income taxes would be subject to a special "per-country limitation" so that those taxes could only affect U.S. income taxes imposed on V.I. source income. Thus, this credit could not exceed an amount equal to U.S. tax on worldwide income multiplied by a fraction the numerator of which is the taxpayer's grossed-up deemed paid dividends from the Virgin Islands and the denominator of which is the taxpayer's worldwide taxable income.

In general, if the total available credit (the sum of the two elements) exceeded the taxpayer's U.S. liability, the taxpayer would carry the credit back or forward to other (post-enactment) years during which the taxpayer made the Virgin Islands limitation election.

If a taxpayer elected the special foreign tax credit limitation under the bill, that election would remove V.I. income and taxes from the calculation of the taxpayer's overall foreign tax credit limitation.

EFFECTIVE DATE

The reduction in Virgin Islands tax rates would generally apply to payments made after the date of the enactment. The elective Virgin Islands foreign tax credit limitation would apply to taxable years ending after the date of enactment.

REVENUE EFFECT

A revenue estimate is not available at this time.

STATEMENT OF AMADEO I. D. FRANCIS, COMMISSIONER OF COMMERCE, GOVERNMENT OF THE U.S. VIRGIN ISLANDS

Mr. Chairman and members of the Subcommittee on Select Revenue Measures, I welcome this opportunity to submit testimony in support of H.R. 5895 which would remove one of the most tenacious obstacles to the development of a stable and diversified economic base in the United States Virgin Islands.

H.R. 5895 would reduce the tax imposed by the Virgin Islands on certain passive types of income paid to United States Corporations from thirty percent to ten percent and would reserve to the Legislature of the Virgin Islands the right to further reduce this tax. Further, and of equal import, the bill would allow recipients of this income to enjoy a full tax credit or taxes paid to the Virgin Islands on that income and thus would eliminate one of the inherent inequities under the current system of taxation.

Under the present mirror system of taxation, a United States Corporation is taxed by the Government of the Virgin Islands at the rate of thirty percent on dividends, interest, rent and other types of passive income received from sources within the Virgin Islands. The tax is imposed on the gross amount of the income without the allowance of any deduction and is withheld at the source. As a result, this passive income is taxed at a higher rate than similar income earned in the United States mainland. Consequently, the tax has had the effect of seriously retarding investments by United States Corporations in the Virgin Islands and of limiting opportunities for firms doing business in the Territory.

The Virgin Islands Industrial Development Program is the primary mechanism through which the Government endeavors to promote and implement its plans for the growth, development, and diversification of the economy. One of its primary objectives is to create new and alternative employment opportunities for its residents, who are citizens of the United States, other than those opportunities currently available in its primary industry, tourism.

In a 1979 survey conducted by the Virgin Islands Department of Commerce, the majority of the firms participating in the Program identified the thirty percent withholding tax as the first and foremost local or federal taxation problem encountered in doing business in the Virgin Islands.

Two of the Virgin Islands largest private sector employers have considered, over the past several years, expanding their facilities through joint venture undertakings with new investors. Such ventures, however, have failed to materialize due to the disincentives presented by the thirty percent tax.

The disadvantages posed by the current withholding tax are most apparent in the area of dividends. Since the dividend income is subject to simultaneous taxation at the level of the company and at the level of the shareholder, several firms in the Virgin Islands attempt to avoid or mitigate this economic double taxation by accumulating earned surplus, in anticipation of a free-free liquidation, rather than declaring a dividend distribution. As long as these earnings remain in the Virgin Islands as surplus they escape taxation by both the Virgin Islands and the United States governments. In this connection, it should be noted that if the withholding tax is made more amenable to collection, the revenues flowing into the Virgin Islands Treasury would not only be enhanced but the dividend received by the United States recipient would be available for reinvestment or otherwise disposed of on the United States mainland.

As disturbing as the problem of the thirty percent tax is in its impact on the repatriation of income and on the Territory's ability to attract new investment, far more serious is its impact on financing opportunities. Mainland banks without a Virgin Islands branch are no longer making short-term or long-term loans to Virgin Islands investors because interest payable to non-resident aliens, e.g. United States lenders, is subject to the withholding tax which diminishes their return. In order to get a reasonable rate of return of a loan, interest rates would have to be raised by as much as a third which in many instances would violate usury laws or become unattractive to the investor. These same disadvantages have acted to entirely close out the mortgage market for the Virgin Islands banking community.

In the case of several nascent businesses in the Virgin Islands, the anolamnies of the thirty percent tax on interest can be devastating, particularly in connection with the sale on credit of equipment, other commercial credit sales, and loans granted by suppliers. A United States lender would merely pass on to the Virgin Islands borrower the tax which the former would have to pay to the Territory. In the case of the person selling the equipment on credit, the interest is more element of the selling price than income from invested capital.

Clearly, the current system of taxation can constitute a barrier to the free flow of trade between the United States and its citizens residing in the Virgin Islands.

At the International level, the United States coordinates its tax system with that of other countries by the use of tax treaties. In many instances the treaties provide for a withholding tax as low as five percent thereby mitigating or eliminating entirely the harsh tax treatment which results from double economic taxation. Inasmuch as these treaties do not apply to the Virgin Islands, the Virgin Islands is placed at a competitive disadvantage with respect to other Caribbean destinations such as Jamaica, Trinidad and Tobago, and the Netherland Antilles. In most instances, interest income is exempt from any withholding taxes.

Through the foreign tax credit provision, the United States appears to have provided for some degree of relief from the tax burden attributable to the thirty percent tax. Section 901 of the Internal Revenue Code provides that a United States corporation with a subsidiary operating in the Virgin Islands, whether incorporated on the United States mainland or in the Virgin Islands, may claim a credit against United States taxes within limitations. Unfortunately, these limitations often preclude the United States recipient from fully using a credit to offset taxes paid to the Virgin Islands.

The United States tax credit is an important factor to United States firms investing or considering an investment in the Virgin Islands. The firm may not be able to recover, in full, the taxes paid to the Virgin Islands if the taxes, after considering the Virgin Islands thirty percent withholding tax, are in excess of the amount the United States is taxing the same income.

Thus, a United States parent corporation with a Virgin Islands subsidiary who is a participant in the Industrial Development Program, may have an effective tax rate as high as sixty-three percent or higher instead of the forty-eight percent tax rate experienced on an alternative United States investment.

Similarly, a United States investment in a country which has a treaty with the United States would be preferable to that in the Virgin Islands. I respectfully suggest that it is inconsistent to offer relief from the burden of double taxation at the international level when such disadvantages remain unrelieved between the United States and its territory, the Virgin Islands.

Over the past two years, the people of the Virgin Islands have witnessed several disastrous economic moves against the development of a diversified and stable economic base in the Virgin Islands. Several of these actions or proposed actions have resulted from the current Administration's foreign policy initiatives, notably the Caribbean Basin Initiative. Others have sprung from the implementation of the Administration's domestic policies and tax reform initiatives.

The projected loss of fourteen million dollars in fiscal year 1982 alone from the Virgin Islands Treasury as a result of the Economic Recovery Tax Act of 1981, the creation of a free trade zone between the United States and the countries of Central America and the Caribbean, the prospect of deregulation of the offshore trades serving the Virgin Islands, the very lifeline of the Territory, as well as other implemented and proposed actions raise dire consequences for the people of the Virgin Islands. To the extent that a reduction in the thirty percent tax would counteract some of the negative impacts of these actions, the reduction may induce beneficial results secondary to its immediate impact on employment and investment in the Virgin Islands.

Gentlemen, the proposal before you today is not an initiative sponsored by the Administration. It is a measure which has its birth in the Virgin Islands where its residents are acutely aware of the pernacious effects of the thirty percent withholding tax. It is a measure which has the full support of both the executive and legislative branches of the Government. It is a measure for which I urge your most favorable consideration.

Thank you

TREATMENT OF VETERANS INSURANCE ORGANIZATIONS

97TH CONGRESS
2D SESSION

H. R. 6218

To amend the Internal Revenue Code of 1954 relative to insurance organizations for veterans.

IN THE HOUSE OF REPRESENTATIVES

APRIL 29, 1982

Mr. DUNCAN introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To amend the Internal Revenue Code of 1954 relative to insurance organizations for veterans.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 501(c) of the Internal Revenue Code of 1954 is amended by adding the following paragraph:

"(23) Any association organized prior to 1880, more than 75 per centum of the members of which are present or past members of the Armed Forces or the spouses or dependents of present or past members of the Armed Forces, whose primary purpose is to provide insurance and other benefits to veterans or their dependents."

SUMMARY AND DESCRIPTION

PRESENT LAW

Present law (sec. 501(c)(19)) exempts from Federal income tax any post or organization of war veterans, or an auxiliary unit or society of, or a trust or foundation for, any such post or organization. To qualify for this exemption, the following criteria must apply: (1) the organization must be organized in the United States or any of its possessions; (2) at least 75 percent of its members must be war veterans, and substantially all of the other members must be veterans, cadets, or spouses (or widows or widowers) of war veterans, veterans, or cadets; and (3) no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual. For this purpose, a war veteran is any person, whether or not a present member of the Armed Forces, who served in the United States Armed Forces during a period of war (including the Korean and Vietnam conflicts).

In addition, in order to be exempt, such an organization must be operated exclusively for one or more of the following purposes: (1) to promote the social welfare of the community; (2) to assist disabled and needy war veterans and their families; (3) to provide entertainment, care, and assistance to hospitalized veterans; (4) to carry on programs to memorialize deceased war veterans; (5) to conduct programs for religious, charitable, scientific, literary, or educational purposes; (6) to sponsor or participate in activities of a patriotic nature; (7) to provide insurance benefits for their members or dependents; or (8) to provide social and recreational activities for their members.

Other exempt organizations.—Present law also provides tax-exemption for two other organizations that provide life, sick, and accident benefits for their members. Fraternal beneficiary societies that operate under a lodge system for the exclusive benefit of its members and provide for the payment of life, sick, accident, or other benefits to the members are exempt from tax under section 501(c)(8), and voluntary employees' beneficiary associations that provide for the payment of life, sick, accident, or other benefits to the members, if no part of the net earnings inures to the benefit of any private shareholder or individual, are exempt from tax under section 501(c)(9).

ISSUE

The issue is whether an income tax exemption should be recognized for associations (organized prior to 1880) of past and present members of the Armed Forces, or of their dependents, the primary purpose of which is to provide insurance and other benefits to veterans or their dependents.

EXPLANATION OF THE BILL

The bill would add a new category of tax exemption for associations organized prior to 1880, 75 percent of the members of which are present or past members of the Armed Forces or dependents of present or past members of the Armed Forces, and the primary purpose of which is to provide insurance and other benefits to veterans or their dependents.

The provisions is intended to benefit the Army Mutual Aid Association and the Navy Mutual Aid Association.

EFFECTIVE DATE

The provisions of the bill would be effective upon enactment.

REVENUE EFFECT

It is estimated that this bill would reduce budget receipts by less than $5 million annually.